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RESPONSE TO CALL FOR EVIDENCE - TECHNICAL ADVICE ON POSSIBLE MEASURES CONCERNING CREDIT RATING AGENCIES

Dear Mr Demarigny

I would like to thank the CESR for having given the opportunity to participate to this technical advice. I look forward to continuing dialogue with the CESR and I remain at your disposal[1] for any questions or queries you may have regarding this comment, based on the results of my Ph.D. in Economics that is about to be finalised[2].

[1] E-mail address : olivier-raingeard@club-internet.fr
[2] My Ph.D. dissertation - "Efficacité de la Notation et Régulation" / "Rating's Efficiency and Regulation" - is under the supervision of Mrs Lubochinsky, Professor in University of Paris II Assas, and should be presented to the jury before the end of the year.

I - TECHNICAL ADVICE RELATED TO THE ISSUE OF INTEREST FOR CREDIT RATING AGENCIES

1-Technical advice related to the issue of provision of advisory/ancillary services by credit rating agencies.

The development of advisory/ancillary services raises some concerns and could alter the comment made below concerning payments for credit ratings (see point I.2). Needless to say that the first task of regulatory authorities will be to identify the different advisory/ancillary services proposed by rating agencies and their affiliates. Recent events concerning the financial industry have shown that conflicts of interest can be difficult to manage. Consequently, in order to ensure that the rating industry keeps its credibility, regulatory authorities and market participants will have to deal with these points. A non-overlapping benefits rule could be difficult to implement due to multiple ratings imposed by regulatory requirements and/or requested by issuers.

I am mainly focusing my comment on rating assessment services. As it seems coherent that issuers wonder what the rating consequences of an action (merger, acquisition...) should be, a simple set of rules could be defined in order to manage this conflict of interest :

- a formalised issuer's request ;
- an explicit statement indicating that the rating assessment does not mean that the effective rating will correspond to the estimated one (it is possible that between the assessment and the realisation of the issuer's action, its credit risk varies. Moreover, actions do not necessarily reach the expected results) ;
- the "prohibition" of a rating assessment when the rating agency carries out a rating action ;
- possibly, the disclosure of the rating assessment by the rating agency or the issuer to investors[3].

For services dealing with the development of "internal rating systems", it should at least be required a clear separation between it and rating activities. Consulting services through "independent affiliates" (which, for example, deal with management, strategic risks…) should be at least regulated by a non-overlapping benefits rule (despite implementation difficulties) or prohibited.

[3] Such disclosure could lead to an infringement of confidentiality requirements.

2-Technical advice related to the issue of payments for credit ratings to credit rating agencies by rated issuers.

Payments for credit ratings

Broadly, it seems admitted by market participants that credit rating agencies manage this conflict of interest because credibility constitutes probably the most important criterion for credit rating agencies. For example, Covitz and Harrison (2003) find evidence that reputation incentive dominates for Standard & Poor's and Moody's[4]. According to my research, rating agencies can have specific credibility ; this finding is, however, different from the one of Jewell and Livingston (1999)[5].

Furthermore, the current fee structure - which consists of a certain percentage of the issue's amount[6] - adopted by the main rating agencies could lead to "a reduction" in "rating shopping" practices. Indeed, the price paid by the issuer seems to constitute an explanatory variable of multiple ratings[7].

Apparently, it is not necessary to disclose the existence of such payments because :

- rating agencies' credibility constitute an incentive so that they manage this conflict of interest ;
- large rating agencies have numerous issuers so that they do not derive a large percentage of their revenues from a single source of issuer ;
- the distinction between solicited and unsolicited ratings (when the latter are clearly identified) reveals implicitly the existence of such payments.

Nevertheless, small agencies can have a more concentrated fee structure. Consequently, in order to increase transparency, it would be efficient to require rating agencies to disclose to regulatory authorities and to investors when issuers exceed a certain percentage of their revenues (this percentage could be defined by market participants).

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[4] "[R]ating agencies appear to be relatively responsive to reputation concerns and so protect the interests of investors". Covitz D., Harrison P., 2003, "Testing Conflicts of Interest of Bond Rating Agencies with Market Anticipation : Evidence that Reputation Incentives Dominate", Finance and Economics Discussion Series 2003-68, Board of Governors of the Federal Reserve System.

[5] Contrary to Jewell and Livingston (1999) who demonstrated that Fitch's rating serves as a tie-breaker and concluded "that the evidence is consistent with the market valuing the ratings of all three raters", I find that Fitch's rating is considered in specific cases.

[6] See for example White L., 2001, "The Credit Rating Industry : An industrial Organization Analysis", Prepared for the Conference on "The Role of Credit Reporting Systems in the International Economy" to be presented at the World Bank, March 1-2, 2001.

[7] This point has been demonstrated in my thesis. Indeed, I find - in searching the issuer's determinants to request a third rating in the United States like Cantor and Packer (1995, 1997) - that the amount of the issue, and therefore the price/fee to be paid, constitutes an element of issuer's decision.

Unsolicited ratings

Unsolicited ratings are valuable for two main reasons. Firstly, despite the fact that rating agencies are mainly building those ratings on public information, they have knowledge of competitors, of the industry… Secondly, it allows rating agencies to cover a large portion of issuers, responding to investors' requests, and to alter "rating shopping" practices.

Nevertheless, a clear policy should be set up in order to guarantee the development of competition. Indeed, the fact that Moody's and Standard & Poor's are rating, in the United States, all public corporate debt issues[8] has probably hindered the development of competition. As an example, it may be stressed that Standard & Poor's admits that it rates "99,2% of the debt obligations and preferred stock issues publicly traded in the United States"[9]. Consequently, in the United States, corporate issuers have two ratings, with or without request. This predominant rating agencies' policy probably affects the development of competition and could lead, paradoxically, to a reinforcement of "rating shopping" practices for rating agencies assigning mainly ratings under request[10].

Even though rating agencies apply specific policies in Europe[11], unsolicited ratings should be regulated by a simple set of rules so as to prevent unsolicited ratings from turning into solicited ones and to guarantee the development of competition :

- rating agencies broadly explain that unsolicited ratings are requested by investors. In order to legitimate this action, formalised requests from a significant threshold of investors would be required ;
- issuers should be protected. In other words, they have to be able to estimate their risk when they choose a rating agency rather than another one. They should know that they could be subject to unsolicited ratings. Consequently, it would be pertinent to define a minimum level under which unsolicited ratings are disallowed. This threshold could be based on the issuer's outstanding debt. This

[8] For example, Standard & Poor's claims that "in any event, as a matter of policy, in the U.S., Standard & Poor's assigns and publishes ratings for all corporate debt issues aver $50 million with or without a request from issuers." Standard & Poor's, 2001, "Corporate Ratings Criteria".

[9] Standard & Poor's, 2003, "Comments of Standard & Poor's on S7-12-34", Securities and Exchange Commission Concept Release : "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 28.

[10] Standard & Poor's and Moody's' policy seems to rely, in the United States, on the First Amendment protection - rating is an opinion - and the so-called "journalist's privilege". Moreover, it seems that rating agencies have to adopt such policy in order to be considered as a journalist. Indeed, in the case In RE Fitch (United States Court of Appeals for the Second Circuit, 2003, Docket Nos 03-7062, 03-7076, May 21), the Court finds that "unlike a business news paper or magazine, which would cover any transactions deemed newsworthy, Fitch only "covers" its own clients. We believe this practice weighs against treating Fitch like a journalist."

[11] See for example : Moody's Investors Service, 2000, "Moody's Cross-border Ratings Policy", Rating Methodology, Global Credit Research, May.

proposition would need proceedings between market participants and regulatory authorities ;

- upon investor's request, rating agencies would be allowed to rate issuers. Two categories of unsolicited ratings - with the possibility for issuers to comment the rating - could be distinguished :
  - unsolicited ratings in which the issuer participates in the rating process ;
  - unsolicited ratings based on public information because of issuer's refusal to participate to the rating process.
- as stated by rating agencies, issuers are an important source of input. Unsolicited ratings, although reliable, have not necessarily the same value as solicited ones. Consequently, unsolicited ratings should be clearly identified through as such (with a "signal" pi for public information for example)[12].

3-Technical advice related to the issue of capital links or any other interest links between rated issuers and credit rating agencies.

It would be appropriate that capital independence should be required. No direct or indirect capital link should exist between issuers and rating agencies, i.e. it should be prohibited or at least disclosed to market participants in order to ensure the credibility of the rating's system[13].

II - TECHNICAL ADVICE RELATED TO THE FAIR PRESENTATION OF CREDIT RATINGS

1-Technical advice related to the level of skills of agencies' staff.

2-Technical advice related to methodologies used for building credit ratings.

It does not seem appropriate to regulate skills of agencies' staff and methodologies used for building credit ratings in order to ensure that rating agencies do not publish "poor quality credit assessments" because those propositions would not necessarily guarantee high

[12] A time period - issuer could not request a rating and rating agency could not assign solicited rating - could be imposed after an unsolicited rating. This set of rules could have difficulties to overcome the First Amendment in the United States.

[13] Concerns about share capital links should be dealt with by regulatory authorities. As a starting point, one could consider the reference to "Associated companies" in Article 9.1 (al.1 and 2) of the OECD Model (2000) to be relevant.

quality credit assessments[14]. Despite the fact that point 3.6 (Registration) considers the opportunity to register rating agencies under a regime which does not give "investors the impression of an absolute guarantee of quality of ratings", it would be more efficient to focus on rating's reliability and credibility (see point VI).

Nevertheless, rating methodologies should be disclosed in order to avoid "biased interpretation of credit ratings". Consequently the following communication requirements should be imposed :

- *rating objectives and rating agency's strategy should be disclosed, considering at least* :
    - default definition and methodologies to calculate default rates ;
    - definition and objective of the rating. For example, a clear distinction between issuer and issue rating should be required ;
    - rating process which means the issuer's request until the surveillance (request, meeting, committee, appeal…).

- *rating methodologies and free dissemination :*
    - general criteria and specific criteria (for sectors for example) should be disclosed[15]. In case of an important shift of rating agency's criteria, it has to inform market participants ;
    - publication of an annual rating performance's study (e.g. Moody's and Standard & Poor's annual studies). Nevertheless, certain agencies would published "biased results" because of a limited number of issuers rated[16] ;
    - Free dissemination of ratings among market participants with motivations for ratings without disclosure of confidential information.

[14] Besides Basel II does not mention this point and focuses on "objectivity". See Technical Advice IV.
[15] The main rating agencies have already adopted this principle.
[16] See, for example, the first historical annual study of Fitch : Fitch, 2001, "Fitch Corporate Bond Default Study, A Decade in Review", Corporate Finance, November 8. Dominion Bond Rating Service does not publish such studies.

III - TECHNICAL ADVICE CONCERNING THE RELATIONSHIP BETWEEN ISSUERS AND RATING AGENCIES

I would like to point out the following considerations without going into details :

- the protection of confidential information is important. Rating agencies have implemented policies and procedures. It seems adequate that market participants together with regulatory authorities define minimum requirements ;
- the need for issuers to "understand" their ratings is important. Disclosure should be imposed on rating agencies concerning their motivations for rating actions (for investors and issuers : which factors explain the action? what are the agency's concerns relative to issuer?), their general and specific rating criteria. Nevertheless, it does not seem opportune to give to issuers "all the methodology" ("how rating agencies restate the figure") because of potential adverse effects this may have (issuers would use the knowledge of the agency's know-how so as not to reduce informational asymmetry) ;
- does the "importance of rating agencies archiving *all information* related to a rating so that a rating decision can be explained (…) at a later stage" constitute an issuer or a regulatory authority concern ? (see point VI for regulatory authority "oversight").

IV - TECHNICAL ADVICE RELATED TO POSSIBLE ENTRY BARRIERS TO THE MARKET FOR THE PROVISION OF CREDIT RATINGS

Entry barriers to the market

According to Moody's Corporation (2003), the global industry share in 2002 is divided as followed (measured in terms of share in revenue) : Standard & Poor's, 40% ; Moody's, 40% ; Fitch, 14% ; Others, 6%. This oligopoly results from several factors : rating agency's credibility and reliability constitute the main factors of the rating industry and it seems doubtful that a new global agency could emerge ; even though the SEC has recognised some rating agencies through the NRSRO's qualification which "regulate" the main market of credit rating, one should consider that it has contributed to this result because :

- the lack of transparency of the NRSRO recognition process has probably dissuaded potential competitors. Indeed, the SEC has not publicised application for NRSRO's recognition and has not defined a planning for its application[17] ;
- the lack of transparency of the NRSRO recognition criteria has probably contributed to dissuading potential competitors[18]. Even though the SEC has stated that "the single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings"[19] and that the Division of Market Regulation examines "officious criteria"[20], the methodology is not transparent and defined, besides few criteria are not necessarily objective or accurate ;
- as stated earlier, the fact that Moody's and Standard & Poor's rate, in the United States, all public corporate debt issues has probably hindered the development of competitors[21]. This fact has probably lead Fitch to develop its activities by acquisitions of some NRSROs, but its market share remains "thin".

Consequently, a regulatory authority should have at least two tasks : the qualification of rating agencies through objective criteria and a transparent process ; the "oversight" of the rating industry (see point VI) in order to address unfair practices, potential conflicts of interest…

The new framework for capital requirements for banks and investment firms

The new framework[22] concerning ECAI could create entry barriers to the rating market. Despite improvements (relative to the NRSRO criteria) such as the disclosure of a "supervisory process", a "validation based on historical experience" and the notion of "political pressures", it has two limits :

[17] See for example the Lace Financial Corporation's letter to the SEC, appealing previous application for NRSRO status (2002) : "I would hope that this time the SEC would process our appeal for NRSRO status on a more timely process (the last application took eight years). It would also be helpful if the Division of Market Regulation could be more forthright with us and tell us in writing what part of the SEC criteria we do not meet."
[18] See for example Rating and Investment Information comments on the SEC's Concept Release (2003).
[19] Securities and Exchange Commission, 1997, "Proposed Rule : Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934", Release No. 34-39457; File No. S7-33-97.
[20] "[T]he organizational structure of the rating organization ; the rating organization's financial resources ; the size and quality of the rating organization's staff ; the rating organization's independence from the companies it rates ; the rating organization's rating procedures ; and whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed". See footnote 19.
[21] This policy is justified by the "journalist's privilege" and the SEC position which only qualifies rating agencies without oversight.
[22] Basel Committee on Banking Supervision, 2004, "International Convergence of Capital Measurement and Capital Standards", Bank for International Settlements, June.

- some criteria do not seem adequate. The one of objectivity[23] does not correspond to the rating's definition[24] and, more importantly, it does not propose an assessment methodology ("some form of validation"). The one of resources seems subjective. Indeed, as stated earlier, it would be more objective to focus on the reliability and credibility of rating agencies, disclose conflicts of interest (economic independence, see Technical Advice I) and manage capital independence (see Technical Advice I, point 3) ;
- the new framework does not recommend national supervisors to "oversee" qualified rating agencies.

V - TECHNICAL ADVICE RELATED TO THE USE OF RATINGS IN EUROPEAN LEGISLATION[25]

Further use of ratings in European Legislation would be encouraged for three reasons :

- rating is a relative measure of credit risk[26] that is reliable. Even though some research, comparing ratings to absolute measures of credit risk (which use market data[27]), evidence the superiority of the latter [Kealhofer, Kwok and Weng (1998), Delianedis and Geske (1999), Kealhofer (2003)…], according to Moody's[28] (2003) credit rating seems to offer the same power as absolute measures when a long term horizon is retained ;
- rating agencies assign "stable" ratings so as not to give "false signals" to investors. According to Moody's (2003), absolute measures of credit risk are much more volatile than ratings ;

[23] If this term has been chosen so as to avoid giving investors the impression of an absolute guarantee of quality, other ones could have been retained.

[24] "There are no formulae for combining scores to arrive at a rating conclusion (…) it is critical to understand that the rating process is not limited to the examination of various financial measures. Proper assessment of debt protection levels requires a broader framework, involving a thorough review of business fundamentals, including judgements about the competitive position and evaluation of management and its strategies. Clearly such judgements are highly subjective…". Standard & Poor's, "Corporate Ratings Criteria".

[25] Concerning private contracts, the use of ratings would create "rating triggers" - not necessarily disclosed to rating agencies and investors - which can have adverse effects [for further details see for example Moody's (2002) and Raingeard (2003)].

[26] See for example, this quotation from Moody's Investors Service, 2003, "Measuring The Performance of Corporate Bond Ratings", Special Comment, Global Credit Research, April : "Moody's primary objective is for its ratings to provide an accurate relative ranking of credit risk at each point in time, without reference to an explicit time horizon (…) Moody's does not manage its rating to achieve accuracy or to maintain constant default rates by rating categories."

[27] The use of market data points out questions related to their informational signification. See for example Lubochinsky (2002).

[28] For an absolute measure of credit risk, Moody's employs "bond market-implied ratings".

- the IRB approach "admits the reliability of ratings by allowing banks" to develop their own rating system with "rating agency mapping"[29].

Nevertheless, in order to use credit ratings in European legislation, CESR would have to consider the following points :

- according to my research, regulation based on ratings could lead to the development of "multiple ratings" and, consequently, to "rating shopping" practices. Based on similar research to find explanatory factors of third rating that Cantor and Packer (1995, 1997) performed[30], I confirm some of their results and I find that the amount of the issue constitutes a determinant of a third rating and evidence that firms seem to meet regulatory requirements ;
- the regulatory authority should qualify (and not just register) reliable and credible rating agencies. The latter should also be "controlled" in order to ensure that the use of ratings in European legislation does not generate adverse effects. For example, the regulatory authority should try to prohibit "preliminary corporate credit ratings"[31] - used by some current NRSROs - which probably lead to reinforce "rating shopping" practices and "issuer influence"[32].

Consequently, the use of ratings in European legislation should not lead to the development of "rating shopping" practices, contrary to the potential impact the "Standardised Approach" proposed by Basel II may have (the methodology defined for the risk weightings for corporate claims could constitute an issuer's incentive to seek multiple ratings[33]). To sum up, a regulatory authority should qualify and "control" rating agencies.

[29] "Banks may associate or map their internal grades to the scale used by an external credit assessment institution or similar institution and then attribute the default rate observed for the external institution's grades to the bank's grades." Paragraph 462 in Basel Committee on Banking Supervision, 2004, "International Convergence of Capital Measurement and Capital Standards", Bank for International Settlements, June.
According to Thoraval and Duchateau (2003), certain banks prefer rating stability through the cycle - so as to compare their rating to rating assigns by rating agencies - and can incorporate market data (in France, major banks have chosen this approach).

[30] Cantor and Packer (1995) refute "convincingly the hypothesis that ratings uncertainty due to disagreements between Moody's and Standard & Poor's ratings increase the likelihood of obtaining a third rating to resolve the difference." They find that "the most important determinants to get an additional rating are firm's size and age". Cantor and Packer (1997) claim that "there is no evidence that firms seek third rating specifically to help meet regulatory requirements."

[31] After the initial contact between the agency and the issuer and the communication of the appropriate information, the first one provides a preliminary rating which can be comprise within a range (e.g. a preliminary rating A+/A with a probability of realisation indicated).

[32] Could the "journalist's privilege" impede the application of such proposition in the United States ?

[33] See Raingeard O., 2003, "Comments of Olivier Raingeard", Securities and Exchange Commission Concept Release : "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 27.

VI - REGISTRATION

Does CESR consider it appropriate that credit rating agencies should be registered in the EU ?

CESR should consider the following aspects. According to Moody's Corporation (2003), Europe constitutes its main dynamic market[34] and the rating agency identifies an important potential for "disintermediating bank loans in the six largest European economies"[35]. Consequently, Europe is a growing opportunity for rating agencies thanks to corporate coverage potential. Furthermore, rather than each national regulatory authority defining its own system, it seems more coherent and logical to harmonise European financial markets. Taking into account these elements, it would be appropriate to register/qualify credit rating agencies.

Nevertheless, it is important to bear in mind that the SEC, which regulates the first market of the rating industry, has not yet defined a "proposed rule" and considers that the rating is an opinion with the consequences attached[36]. It does not seem that Europe adopts this point of view. More precisely, it seems, according to Katiforis, that even though rating is an opinion, the analogy - with journalist - "does not hold much water from the moment that ratings become part of the regulatory mechanism of financial markets"[37]. This is the reason why the registration of rating agencies in the EU could lead to the creation of a system quite different than the American one.

If so, how and under what type of regime, bearing in mind the need to avoid giving investors the impression of an absolute guarantee of quality of ratings ?

According to my comments, if it is considered appropriate to require registration of credit rating agencies in the EU, sole registration does not seem sufficient. It seems necessary to qualify rating agencies and to "control" them. In order to avoid giving investors the impression of an absolute guarantee of the quality of ratings, it should be stressed that, according to their definitions, credit ratings constitute a relative measure of credit risk. In order to increase competition (which seems to be the European wish), the regulatory authority

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[34] See "Revenue Distribution and Growth by Region", p11, in Moody's Corporation, December 2003.
[35] See footnote 34.
[36] Does it have difficulties of defining a proposed rule because of the First Amendment which seems to "protect rating agencies system" according to the "big three" ? Standard & Poor's (2003), in his SEC Concept Release's comment, develops particularly this point.
[37] Katiforis, 2004, in "Report on role and methods of rating agencies", Committee on Economic and Monetary Affairs, European Parliament, A5-0040/2004, January 29.

should also qualify reliable and credible rating agencies, which offer specialised skills (limited sector of the debt market, limited geographic area…)[38].

1-Qualification of rating agencies.[39]

As emphasised earlier, qualification must be mainly based on rating's reliability and credibility. The main obstacle the regulatory authority will have to overcome is the distinction between reliable and non-reliable rating agencies.

Rating agency's (relative) reliability.

Rating is a relative measure of credit risk which is relatively stable. Furthermore, the performance of ratings can be estimated from an absolute point of view. Consequently, the reliability of rating agencies could be examined through the following methodology :

a - Analysis of the rating agency's performance thanks to[40] :

- *an analysis of the rating's relative performance* which could be focused on :
    - the relation rating-default rate (annual and cumulative) so as to "appreciate" agency's rating scale[41] ;
    - the agency's "power curve" in order to appreciate how the agency distinguishes defaulters and non-defaulters ;
    - the agency's transition matrices in order to "appreciate" rating's scale and stability.
- *an analysis of the rating's stability* in order to examine[42] :
    - rating actions : the frequency of rating's upgrades and downgrades ;
    - rating changes : the rating variation ;
    - rating reversals.
- *an analysis of the rating's absolute performance* which would deal with the following elements :
    - an analysis of annual default rates for investment and speculative grade issuers relative to their historical mean and determinants[43] ;

[38] Such as the qualification of Thomson Bank Watch by the SEC.
[39] This proposition mostly deals with the qualification of agencies which assign corporate credit ratings.
[40] The structure of the analysis of the agency's performance (relative, stability, absolute) is issued from Moody's Investors Service (2003). The adds-in can differ.
[41] "Mortality rate" could also be analysed [See Altman (1989) for a definition].
[42] Fore more details, see Moody's Investors Service (2003).
[43] According to numerous [Jónsson et Fridson (1996) Jónsson, Fridson et Zhong (1996) Helwege et Kleiman (1996) Fridson, Garman et Wu (1997)] and own researches, explanatory variables of speculative grade default

- an analysis of average rating prior to default in order to appreciate the agency's capacity to anticipate default ;
- possibly a comparison between rating and absolute measures of credit risk.

This examination of the reliability of ratings would constitute an objective analysis of the rating agency's quality. Nevertheless, due to statistical problems for small rating agencies - small number of issuers rated -, comparisons of rating agencies should be performed.

b - Comparison of rating agencies' performance should be based on the following points :

- a comparison of rating agencies' relative performance, considering their "power curve"[44] ;
- a comparison of rating agencies' absolute performance, considering their average rating prior default[45] ;
- a comparison of stability of ratings based on the three measures quoted ;
- a comparison of rating differences. Numerous researches identified rating's differences between rating agencies [see for example : Cantor and Packer (1995 1997), Jewell and Livingston (1999), Packer and Reynolds (1997), Packer (1999)]. According to my research, rating differences between current NRSROs are due to rating criteria's differences and/or rating methodology's differences[46].

This approach should be based on an exhaustive sample in order to overcome statistical limits and ensure the most objective analysis.

To conclude, this global methodology should lead to an objective (not absolute) analysis of the rating agency's performance.

Rating agency's credibility.

The regulatory authority should deal with the criteria of credibility and the rating agency's effective credibility.

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rates are the economic and monetary environment, the sample's distribution, the lag between the issue and the default event…

[44] This methodology would probably suffer statistical problems.

[45] According to my research, Moody's, Standard & Poor's and Fitch propose different abilities to anticipate default. See also footnote 44.

[46] One should consider the difficulty to evaluate rating agencies' using different approaches (for example, the Japanese rating agencies. See Raingeard (2003) for further details).

a - Credibility's criteria should mainly be based on the following points :

- *rating's objectives and rating agency's strategy* should be disclosed (see Technical Advice II) ;
- *rating's methodologies and free dissemination* (see Technical Advice II) ;
- *the organisational structure* that is to guarantee rating agency's independence, minimise and/or manage (potential) conflicts of interest, protect confidential information :
    - the independence of the rating agency should deal with capital relationship (prohibit or disclose), economic independence[47] (disclose) and political independence, the latter being "guaranteed" by the definition of objective qualification criteria ;
    - "Code of Ethics" with the definition of minimum requirements about rating agency's analysts (compensation, ownership interests…), clear separation between commercial and rating activities, policies and procedures in order to manage potential conflicts of interest ;
    - policies and procedures in order to protect confidential information[48].

b - The analysis of the effective credibility (not necessarily discriminatory) should be based on two approaches :

- a qualitative credibility, based on market participants' opinions ;
- a quantitative credibility that will require the examination of the rating's impact on bond prices for example.

This methodology for the recognition of agencies would allow the qualification of reliable and credible credit rating agencies based on objective criteria, thus this would minimise entry barriers. Nonetheless, this may not be sufficient and the regulatory authority should have three functions.

[47] That is to say that an agency which derives a certain percentage of its revenues from one sole client (5%, 10%…, the threshold could be determined by the regulatory authority together with market participants) should disclose it.

[48] Rating agencies have already defined such requirements (analysts, confidential information..). See for example Moody's, 2003, "Comments of Moody's Investment Service on S7-12-03". Nonetheless, minimum requirements should be imposed.

2-Regulatory authority's functions.

The regulatory authority should have three functions in order to ensure the credibility and reliability of the rating system.

a - Rating agency's qualification through a transparent process :

- rating agency's request should be disclosed ;
- public comments could be solicited ;
- the decision should be taken "in a short time period", should be motivated (on the criteria) and communicated to market participants.

b - Rating agency's reliability and credibility control.

One may consider that the increase in competition leads to the exacerbation of "rating shopping" practices. Consequently, the control of rating agency's reliability and credibility may be divided into two parts :

- the first part, on an annual basis, aims at allowing the control of the rating industry. An annual certification (as proposed by the SEC) could be adopted. By this mean qualified rating agencies would communicate new procedures, services… The regulatory authority will then be able to ensure those new elements do not constitute unfair practices and do not generate "mismanaged" conflicts of interest. Instead of having measures imposed by the regulatory authority, the latter could supervise (with market participants' proceedings) the existing and new procedures in order to guarantee the flexibility of rating process ;
- the second part (every three or five years for example) would consist of reviewing qualification's criteria and, especially, the one of reliability.

c - Rating industry's surveillance and "oversight".

So as to ensure the reliability and the credibility of the rating industry, three points could be considered :

- rating agency's activity and competition : for example, unsolicited ratings should be regulated and preliminary ratings should be prohibited ;
- rating agency's activity and independence : conflicts of interest should be particularly studied ;

- responsibility of rating agency : anti-competitive and unfair practices (unsolicited rating turned into solicited for example) could be examined. An “ex post” control could be defined but this procedure should be extremely precise and limited[49].

[49] This point (and the others) could be subject to close contact with the US authorities. Rating agencies (Standard & Poor’s for example) seem to accept “enforcement investigation” (Standard & Poor’s, 2003, “Comments of Standard & Poor’s on S7-12-03”). Nonetheless, this process should be limited in order not to generate adverse effects (for instance, rating agencies could be reticent to rate issuers who operate in volatile sectors).

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