



BBA / ICMA / LIBA / JOINT RESPONSE TO EUROPEAN COMMISSION CONSULTATION ON:

- A DRAFT DIRECTIVE / REGULATION ON THE AUTHORISATION, OPERATION AND SUPERVISION OF CREDIT RATING AGENCIES (CRAS); AND

- POLICY OPTIONS TO ADDRESS THE PROBLEM OF EXCESSIVE RELIANCE ON CREDIT RATINGS.

Introduction

The British Bankers' Association (BBA), the International Capital Market Association (ICMA) and the London Investment Banking Association (LIBA) welcome the opportunity to respond to the Commission's two consultations on credit rating agencies. This joint response represents the collective view of all our members.

The BBA is the leading association for the UK banking and financial services sector, speaking for 228 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

LIBA is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its Members on all aspects of their business – both international and domestic – and promotes their views to the authorities in the United Kingdom, the European Union and elsewhere.

ICMA is the self-regulatory organisation and trade association representing constituents and practitioners in the international capital markets with a European focus. ICMA's members are located in 49 countries across the globe, including all the world's main financial centres, and currently number some 400 firms in total.

Our response focuses on the implications, usefulness and cost of ratings provision in the EU and to EU markets. It is organised into the following sections:

- 1. Summary of key messages
- 2. Overarching issues
- 3. Options for regulatory structure
- 4. Proposals for addressing excessive reliance on ratings
- 5. Detailed comments on draft Directive/Regulation on the authorisation, operation and supervision of credit rating agencies

In addition, we have read the submission of SIFMA and are in general agreement with their analysis and endorse their conclusions.

1. SUMMARY OF KEY MESSAGES

Draft Directive on the Authorisation, Operation and Supervision of Credit Rating Agencies

We share the Commission's desire to examine the role of CRAs in the market turmoil and to formulate appropriate responses if these are justified by the application of the better regulation principles. However, we would highlight that the overall objective of the Authorities should be to regain and maintain market confidence with a view to delivering long term financial stability. Regaining market confidence should be the prime focus. We support the subsequent objectives of the Commission to achieve this prime objective, which includes conflicts of interest management, high quality ratings and appropriate transparency levels of CRAs. All measures to achieve the subsequent objectives should be implemented proportionately, and as a means to assist in the restoration of market confidence. We consider that much of the draft Directive/Regulation will, in practice, prevent the market from functioning efficiently. The Commission should therefore:

- **Focus public policy action on the needs of users of credit ratings, which is to ensure that enough information is provided to users on the risks or factors that would result in rating volatility;**
- **Avoid intrusive authorisation and conduct of business requirements that would add cost and diminish the usefulness of and confidence in ratings;**
- **Bear in mind that intrusive requirements may give rise to moral hazard by encouraging investors to rely unduly on regulatory oversight of credit rating agencies;**
- **Not propose an authorisation and regulation regime which would be out of line with the actions of the authorities in the rest of the world, and which also appears to overstep the political direction set out by the ECOFIN Council;**
- **Build as far as possible on existing mechanisms for registration and supervision of credit rating agencies, and not seek to duplicate them. Any legislative output should cross reference the**

extensive work that has already been done by IOSCO and specifically the IOSCO code of conduct. Clearly however the code itself should not be simply transplanted into EU law verbatim.

- **Ensure that any regulatory response robustly addresses the danger that there may be political influence on the credit rating process, and subsequent methodologies**

We would highlight **that the consultation has not been prepared or conducted in accordance with better regulation principles.** In particular there has been no market failure analysis that indicates the need for the EU to take a differentiated approach to this issue, no consideration of the range of possible policy options, and limited involvement of stakeholders in that process. The short consultation period, is not conducive to a well-considered legislative proposal. While we accept that there is a desire to take action in response to recent market events, it is not appropriate to rush through hastily drafted legislation. Indeed, the recent turmoil makes the application of better regulation principles even more important to ensuring the delivery of a targeted, cost effective regulatory response which supports the recovery of the markets rather than to its detriment.

We believe that there are many unresolved and complex issues in the possible authorisation of CRAs. We would strongly recommend a further period of consultation to allow both the industry and the Commission to formulate appropriate policies and considered legislation. We do not consider that this fast track approach to legislation will create an optimal outcome for any participants, be it regulatory, industry or investors.

We strongly oppose a purely EU legislative approach that involves authorisation and supervision by EU regulators. Financial markets, and therefore, the scope of rating agency activities, are global. It is unclear whether the proposals have benefited from co-ordination with other legislators and regulators worldwide. It would be better to have an internationally agreed solution that focuses primarily on delivery of compliance with the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (the Code) than an EU authorisation scheme which would be out of line with it. EU proposals in this area should therefore align with the outcome of the IOSCO review on how to ensure compliance with the Code at an international level and therefore it is more appropriate for EU regulatory proposals to be deferred. If EU regulatory action is still considered necessary in the short term, a registration approach would be not only more appropriate but also more achievable.

In addition the **proposals have an extra-territorial impact** that will unnecessarily complicate the business of European financial firms. Owing to the international nature of financial markets, it is not possible to draw a clear line between the investors, issuers, and the rating services provided to them inside and outside the EEA. It is inappropriate for the draft Regulation/Directive to require, for example, a Japanese rating agency, which

rates purely Japanese entities, to set up offices in the European Union because European investors wish to use the ratings it produces. Furthermore, it is unclear what effect a withdrawal of authorisation of a CRA from a third country would have on that agency or indeed for an investor who continues to use its rating. We question the legitimacy and enforceability of such an approach and fear it would complicate the agreement of a global approach.

Furthermore the draft proposal fails to deliver the conclusions of ECOFIN in July 2008, which supported a strengthened oversight regime and the objective of strengthening international cooperation to ensure a stringent implementation of internationally agreed principles by way of an EU registration system. In addition, the draft proposal is not aligned with either the advice received from the Committee of European Securities Regulators (CESR) or the European Securities Markets Expert Group, which were less intrusive. These proposals seem to be discordant with the recommendations of the Financial Stability Forum and the Committee on the Global Financial System.

We do not support either option the Commission puts forward for the authorisation and supervision of rating agencies. It is not appropriate to create a new Agency or give CESR Agency status for the purpose of authorising rating agencies, nor to give CESR a mandate to decide which national authority should be responsible for regulation. The proposal as outlined is likely to cause regulatory confusion. We think that the inter-linkages between a system of registration and recognition for regulatory capital purposes require further consideration to avoid duplication of processes which would increase costs.

The highly prescriptive nature of the draft legislation including extensive conduct of business requirements, is unlikely to deliver the desired result and would set a bad precedent. A principles-based approach would be more effective, while still allowing for financial innovation and international co-operation. The focus of any regulatory measures should be on disclosure and transparency to ensure that market discipline provides the most effective control. Investors should shape what is needed from CRAs. The Commission should be mindful that this proposed legislation will act as a further barrier to entry, reinforcing the currently narrow range of major agencies. It is competition that drives improvements and the Commission should not undermine this force.

Aspects of the detail of the draft proposal will be costly for rating agencies to implement, and **the benefits are not apparent, thereby placing an unnecessary burden on the financial services industry as a whole.** The proposals are disproportionate in a number of areas and will cause disruption to the market. For example:

- Requiring rating agencies in certain circumstances to withdraw ratings of particular entities or transactions (for example, they begin to exceed the 5% revenue rule in Article 9 3. a) will cause significant practical problems for investors and undermine market confidence.

- Prohibiting ratings where there is weak data would stifle innovation and would lead to migration of new products away from the EU. Rating agencies should be allowed to rate provided that they make clear the weaknesses and issues surrounding data, so that investors can make up their own minds.

While we support improved disclosure by rating agencies **we oppose a legislative requirement for differentiated rating for structured finance instruments**¹. It would involve costly system changes, would not provide useful information for investors, and would distract investors from where their focus should be. Specifically we oppose Article 14 (3) in the draft Directive. It is more important to ensure that rating agencies provide investors with sufficient information on the factors that would influence the volatility of the rating.

In summary we do not support a regulatory approach by the Commission to address CRAs. However if there is to be some form of registration our preferred approach would be:

- A registration regime, supported by Directive text that sets out high level principles (in line with the code) and which places responsibility for registration, monitoring and enforcement with the national authorities, and which provides for mutual recognition.
- A clear division of responsibilities and powers between the lead (home) supervisor and the host supervisors.
- A joint Committee of CEBS and CESR to produce guidelines to deliver convergent implementation of the Directive by national authorities, making reference as appropriate to the Code.
- Supervisory co-operation between national authorities regarding registration, monitoring and enforcement.
- Removal of any duplicative material within the CRD.
- Clear, independent and objective criteria for determining where a CRA should be supervised from.
- An annual report published by CESR on the compliance with the Code.

Policy options to address the problem of excessive reliance on ratings

We support the objectives of encouraging investors to undertake proper due diligence and not relying excessively on the rating. As the Commission is aware there is a work stream within the “ten industry

¹ We recognise that amongst institutional investors there is some diversity of opinion regarding this topic.

initiatives” that is developing industry guidelines on credit assessment and valuation. This initiative will go a significant way to addressing regulatory concerns in this area. **The Commission's proposal to impose authorisation and much more stringent regulation on CRAs seems to be at odds with a policy of reducing investors' over-dependence on credit ratings and increasing their own due diligence.** It would be better to focus on what investors should expect of CRAs, which is information to provide a better understanding of what ratings tell them, not impose a range of requirements and restrictions which are of limited use from investors' point of view.

Within Proposal 1 we are however seriously concerned by the implications of the suggested requirement for firms to deduct securitisation exposures where they have failed to look ‘beyond’ the ratings. There has been no consultation on the comitology amendment that is alluded to. We are therefore uncertain as to the nature of the proposed change. However, in light of greater use of models in the regulatory framework we would, in principle, support use of firms’ own risk analysis in the capital calculation for securitisation positions. But, we do not think it appropriate to apply the standards found elsewhere in the IRB approach to all investors in securitisation exposures. We think that the focus on improving the quality of ratings should remove perceived problems with the use of ratings in the CRD. In addition we highlight the proposed change in the April CRD consultation to Annex V point 8 which clarifies that investors should also undertake sufficient risk analysis.

2. OVERARCHING ISSUES

Better regulation:

It is essential that the principles of better regulation are followed, in the light of recent events to ensure that any regulatory response is necessary, targeted to the objective, proportionate, clear and transparent, and mindful of the competitiveness of EU financial services firms.

We are therefore very concerned by the absence of market failure analysis, particularly as other international bodies considering this issue have indicated that there is no evidence to suggest that regulation would have averted the events of last Summer and that they would advocate other solutions (a standard setting body, or regulatory work to ensure compliance with the Code) before regulation is contemplated.

It is unclear how an EU proposal for regulation would integrate into the broader international efforts such as those proposed by IOSCO.

We are also very concerned that the proposals are disproportionate. The imposition of such prescriptive rules is likely to impose significant cost on the rating agencies if they operate in Europe. Such costs would be passed on to the firms that use ratings and would therefore harm the ability of EU firms to compete in international markets. Without a cost benefit analysis this impact

is difficult to determine. The brevity of the consultation period makes it very difficult for the industry to address this shortcoming in the consultation. We would also note that the intention of the draft proposal is not apparent in a number of areas – for example how CRAs who have a number of subsidiaries in the EU will be treated. The Commission should focus on CRAs as global entities and not require separate authorisations for subsidiaries in different member states. It is also not clear how competent authorities would be able to determine whether non-executive directors have the appropriate skills. Fundamental questions of scope and operation need to be clear in any legislation.

Geographic scope:

We are concerned that the proposals inadequately address the issue of geographic scope and as a result are extra-territorial in nature. The Commission's draft Directive/Regulation proposal would impose EU regulation on rating agencies by virtue of the use of their ratings by the various types of financial services firms, independent of any particular Directive in which their use is permitted or mandated. The implication of this proposed Directive is that any legal person that issues ratings, and whose ratings are used in the EU could be forced to establish a legal presence in the EU and to apply for authorisation. It is unclear how the Commission would enforce such a requirement.

This approach is neither legitimate nor enforceable. It is not consistent with the desire of ECOFIN for an international solution, and as such a Euro-centric approach risks alienating third countries. In addition it would not facilitate cross border transactions through mutual recognition, exemption regimes, or elimination of bureaucratic obstacles. Viable alternatives exist that allow for regulatory scrutiny and ongoing monitoring and supervision as necessary. We believe, as a minimum, that the regulation of CRAs should be linked to the use of ratings in Directives, as is currently the case with the ECAI regime in the CRD. Such an approach would permit rating agencies that do not wish their ratings to be used for purposes outlined in Directives to be exempt from the Directive/Regulation, much in the way that US rating agencies do not have to apply for Nationally Recognised Statistical Rating Organisation status in the US.

Authorisation:

The case for an authorisation regime seems to rest upon the assertion that there has been 'a manifest failure of self regulatory effort, both formal and informal, to ensure high standards of independence, integrity, and professional diligence' and a misconception that ratings are 'reliable and accurate pieces of information'. We would dispute both these points. The ESME report concludes that rating agencies have a long and good track record in relation to the rating of corporates. And while ESME indicates that there have been failings in the performance of 'certain asset classes', they do

not recommend full regulation. We would also highlight that ratings represent an evidence-based assessment of the relative credit risk of an instrument. Any future legislation on rating agencies should have a clause built into it to ensure periodic review of the directive to ensure it remains in line with the IOSCO code.

The EU proposal does not discuss alternatives to authorisation of CRAs and nor does it analyse the impact of authorisation. By imposing an authorisation requirement, the EU will exclude a CRA from the provision of its service, even if the CRA does not wish its ratings to be used for purposes outlined in EU Directives. This proposal therefore constitutes a potential barrier to competition and entry to the market.

It is clear that the Commission proposal builds on standard provisions that are a feature of other Directives with authorisation and supervision provisions, such as MiFID. However we believe that it is not a straightforward exercise to import such provisions into a regime for credit rating agencies. For example, the existing set of institutions that are to be caught by this proposal are relatively few in number, based mostly outside the EU. Additionally, unlike banks and investment firms, they do not hold/invest clients' money or assets. Therefore any imperative to regulate them is quite different. Further consideration should be given to a different type of regime, the foundation of which is probably to be found in the existing international standards that are either voluntary, self-regulatory/code of conduct or registration plus recognition e.g. CRD/ECAI

Alternative options include:

1. Mutual recognition of third country regimes
2. EU standard setting body
3. An enhanced IOSCO code with review by CESR of compliance with it potentially embodying an external annual review (currently the CRAs write in and say how they have complied) and the creation of an Advisory group to CESR to advise them on significant developments and trends in the credit markets and ratings/trends in ratings that are causing concern. Advisory group made up of users, issuers, credit experts, academics etc.

Regulation or Directive:

Although, as noted above, we are in favour of a globally agreed framework for the treatment of CRAs and therefore a deferral of any EU proposals, in our view it would be much more effective to have a principles-based directive and to allow room for innovation and market developments in implementation rules as well as flexibility for global regulatory coordination. We are also concerned that such prescriptive legislation could set a precedent. We are concerned that there should be a clear prohibition in a principle based directive on regulators intruding in methodologies. National regulators should not politicise ratings on local issuers.

If the Commission does decide to proceed with EU legislation, it should be in the form of a Directive rather than a Regulation, for the following reasons:

- The proposals are not self contained requirements that are directly applicable to the entities under consideration: they also apply to supervisory bodies.
- Member States will therefore need to introduce national legislation to implement the supervisory aspects (either setting up a new supervisory body or imposing new obligations on an existing one).
- Many of the requirements are general standards or principles and would therefore require interpretation to implement in practice, for example regarding the appropriate level of experience.
- It is not possible to amend a Regulation through comitology and therefore there will be less flexibility to adapt EU regulation to evolution in the Code.

It would be much more effective to have a principles-based directive that allows for innovation and market developments in implementation rules as well as flexibility for global regulatory coordination.

Transitional Issues:

The Commission should consider the transitional issues surrounding the authorisation (and / or removal from authorisation) or recognition of a CRA. If a CRA for whatever reason were to be denied recognition or have its recognition removed, the industry would need significant time to adjust to such a change.

3. OPTIONS FOR THE REGULATORY STRUCTURE

While we consider it appropriate for CESR to continue its role to monitor CRAs performance with respect to the implementation of the IOSCO Code, we strongly oppose the concept of EU authorisation and full regulation for CRAs. This approach is not consistent with the international co-operation and regulatory oversight envisaged by ECOFIN, and insufficient evidence has been produced to demonstrate that it is necessary. In particular we would note that CESR's own report indicates that Regulation should only be used as a last resort if other methods for international co-operation have failed. ECOFIN supported a system of registration and oversight.

Should a full authorisation solution be pursued in the EU, we strongly oppose both Options 1 and Option 2 for the regulatory structure. Ascribing any authorisation powers to a Level 3 Committee would create a potential conflict

of interest and also of accountability for the individual supervisors who make up CESR. It would be more appropriate to build on the ECAI recognition process that is present in the CRD and the monitoring activities of CESR in respect of the Code. We consider that such an approach is closer to the conclusions of ECOFIN and would avoid duplication and excessive costs.

The ECAI recognition process has worked well to deliver a convergence of approach. This approach relies on broad principles and mutual recognition provisions outlined in the Directive text, supplemented by CEBS guidelines. It is important to note that the CRD requirements already overlap with the issues considered by the Code. In practice supervisors have also worked together to arrive at a common view on the recognition of the larger international agencies. While the shared view is not legally binding, national supervisory responsibilities still need to be adhered to, and the recognition approach has provided the basis for international co-operation and a cost effective process for the CRAs concerned.

Our suggested alternative approach therefore comprises:

- A registration regime, supported by Directive text that sets out high level principles (in line with the code) and which places responsibility for registration, monitoring and enforcement with the national authorities, and which provides for mutual recognition.
- A clear division of responsibilities and powers between the lead (home) supervisor and the host supervisors.
- A joint Committee of CEBS and CESR to produce guidelines to deliver convergent implementation of the Directive by national authorities, making reference as appropriate to the Code.
- Supervisory co-operation between national authorities regarding registration, monitoring and enforcement.
- Removal of any duplicative material within the CRD.
- Clear, independent and objective criteria for determining where a CRA should be supervised from.
- An annual report published by CESR on the compliance with the Code.

We have the following comments on the options the Commission has presented.

Option 1

It is not appropriate that CESR should be responsible for the determination of the competent authority that would be designated home supervisor. Banks and investment firms are not required to apply to a Level 3 Committee to determine who will be their supervisor. Firms set up their organisation where

it best suits their business model and are regulated accordingly. It is not apparent what added benefit CESR's involvement in the determination of the supervisor would deliver in terms of promoting convergence of the implementation of the authorisation requirements, unless it is intended that CESR should become more directly involved in the authorisation process. Such an approach would cut across competent authorities' national responsibilities. Furthermore the approach would give CESR the ability to take away supervisory authority from a jurisdiction where a legal entity is present and which therefore has a legitimate interest.

We agree, in line with the CRD requirements, that any supervisory activity should be undertaken by competent authorities, and we support Member States work towards supervisory convergence. However, this legislation should not be used to require the introduction of a community dimension mandate into the objectives of national authorities (Article 19, applicable to both options 1 and 2). Action is already being taken elsewhere under the June 2008 ECOFIN Conclusions to introduce a task for supervisory cooperation into competent authorities' national mandates. Such a requirement here has the potential to cause conflicts between competent authorities' national and EU responsibilities.

Any regulatory framework would have to be based on the location, mind and management of the legal entities within the CRA group. Any other approach would be inconsistent with the approach taken in the Post BCCI Directive (1995/26/EC). Currently, as the consultation paper acknowledges, how the home supervisor would be determined is not apparent. The home regulator should be determined in accordance with clear and objective criteria. The CRAs should be free to organise their group structure around these criteria as they see fit.

We understand the Commission's desire not to undermine the authority and interests of host Member States' competent authorities, but note that the regulatory framework that has been established, for example, for credit institutions and investment firms relies on the principle of delegation providing that minimum harmonised criteria have been satisfied. Thus a bank may establish a branch in another EU Member State or provide cross border services and the host member state has few remaining powers or responsibilities in relation to the firm that is authorised to take deposits and investments from the citizens of the host member state. We also note that recent EU discussions on the overall supervision of EU financial groups has been in the direction of greater authority for the lead supervisor even though this is intended to be supported by close cooperation and collaboration with other relevant supervisors. Hence, the proposals in relation to CRAs which would allow for the intervention of a host jurisdiction are inconsistent with the treatment of banks and investment firms, which has been striving to ensure a streamlined and consistent approach across a group.

A competent authority should only have a say in the regulation of a CRA group if there is a legal entity in its jurisdiction. It is inappropriate for a competent authority to be able to influence the supervision and enforcement

of the regulatory criteria if it has no regulatory remit to do so. Although we note the introductory remarks to the draft Directive/Regulation state that the provisions 'do not interfere with the content of ratings', we are concerned that the regulations as currently drafted imply that a competent authority (whether it has supervisory powers over a CRA in its jurisdiction or not) would have power over the rating methodologies used by CRAs in relation to rated entities in its jurisdiction. Any legislative sanction for competent authorities to interfere in the rating decisions made by CRAs will undermine market confidence. In addition such intervention would also undermine the provisions of the CRD which require independence from external political influences or constraints and from economic pressures that may influence the credit assessment. It is vital that rating decisions are independent. We are concerned that there should be a clear prohibition in a principle based directive on regulators intruding in methodologies. National regulators should not politicise ratings on local issuers.

The current proposal raises important questions as to how differences of view between home and host competent authorities would be resolved. In part this issue results from the fact that no decision has been made on regulatory architecture. However, the powers that are proposed to be given to both home and host supervisors do not give us confidence that single market efficiency could be achieved. Uncertainty over responsibilities would harm market confidence. The consultation indicates that mediation mechanisms may be created to address this issue. As we have noted in our previous comments, such mechanisms should be voluntary, and should not have legislative burdens placed on them. We would also note that regulatory intervention at a national level will also likely increase the costs of undertaking ratings in the EU and thereby the costs to issuers.

Option 2

We strongly oppose the creation of a Community Agency, either as a new entity or by giving CESR such status. The potential for conflicts of interest between national and EU responsibilities is acute in this proposal. If the Community Agency is a new entity, conflicts may arise because of the ability such an agency will have for co-ordinating the activities of national authorities, which may not coincide with competent authorities' national responsibilities. Giving CESR agency status for this purpose would be particularly harmful because of the potential to undermine CESR's usefulness as a network of national authorities promoting supervisory convergence. We have strongly resisted proposals according any of the Level 3 Committees Agency status in the past for these reasons.

The possibility of such a change to the EU supervisory architecture was considered and rejected as part of the recent review of the Lamfalussy process. As explained above, creating an additional EU body would add no value to the existing cooperation arrangements through CEBS.

Furthermore, as a general principle, giving one body responsibility for authorisation and another or others responsibility for ongoing supervision and enforcement would also cause confusion, overlap and redundancy. Any decisions regarding authorisation need to be taken by the same body that is responsible for ongoing supervision.

There are also a number of unanswered questions surrounding both options:

- What if there is more than one legal entity operating in the group and these are in different jurisdictions – does this mean that the CRA will have to have multiple authorisations? The Commission should focus on CRAs as group entities and not require separate authorisations for subsidiaries in different member states.
- Arrangements for supervisory co-operation can only be determined in light of the legislation which underpins the use of the ratings.

4. PROPOSALS FOR ADDRESSING EXCESSIVE RELIANCE ON RATINGS

As noted above we support the Commission's objective of encouraging investors to undertake their own due diligence and risk assessment and therefore think that it is valid to consider whether the use of ratings within the regulatory framework has contributed to this problem and whether changes should be made as a result. However, the suitability of ratings for use in Directives and the problem of excessive reliance on ratings, while related, are not necessarily issues that require the same solution. The Commission's suggestions are stated at a high level of generality, and the lack of detail and impact assessment has made it very difficult for us to comment effectively. Therefore we have first sought to answer the following questions.

Did the CRD encourage over-reliance on ratings?

In our view it is difficult to know either way whether the regulatory use of ratings has encouraged excessive reliance on ratings. The CRD is cited as a community provision where there is extensive use of ratings. However, it is important to note that the CRD (Basel II) implementation was not in force until 1 January 2008 and at present, the implementation process is still ongoing for many banks. In our view, any reliance of external ratings was not due to the CRD.

In addition the CRD already contains requirements for firms to manage their risks effectively.

Should the CRD be amended to address over-reliance on ratings?

In line with better regulation principles, we think that in answering this question it is important to consider mitigating actions that have been

undertaken already by industry and regulators. We highlight the package of industry initiatives to promote transparency and disclosure in the securitisation markets (given the reference in Proposal 1 we understand that securitisation is the primary area of concern). Several of these work streams are developing, or in the case of ABCP, have developed industry guidelines on the information that investors should be able to expect both at inception and on an ongoing basis, and are looking at ways to ensure that information is accessible. Another work stream is developing a set of industry guidelines for the credit assessment and valuation of securitisation positions.

Should other measures be taken to address over-reliance on ratings?

We consider that the industry initiatives to improve transparency and investor due diligence described above, combined with those to improve the quality of, and regain and maintain investor confidence in, ratings, which are being undertaken by the rating agencies themselves and the international regulatory community, mean that no other measures that need to be taken.

Are ratings still suitable for use within the CRD?

Provisions on ratings were introduced into the CRD to provide an independent risk input into the standardised capital calculation, albeit one that is quite limited in scope. In the case of securitisation, the Basel Committee's decision not to accept full credit risk modelling resulted in the use of ratings in both the standardised and advanced capital adequacy approaches. Although further strides towards credit risk modelling are being made, for example in the work on the incremental risk charge, short of returning to Basel I there will be a need for an independent risk input into the calculation for at least some firms.

The criteria for whether and if so which ratings are suitable for use within the capital calculation are already set out in the CRD and in the CEBS guidelines. Objectivity, independence, transparency and credibility are appropriate criteria for that determination. Members of CEBS are currently undertaking a review of the four international agencies in relation to their continued compliance with the CRD recognition criteria and the appropriateness of the mapping scales. Such action demonstrates that the system is working in line with its design. This supervisory activity combined with the actions being undertaken elsewhere to improve the quality of the rating process lead us to conclude that it is appropriate to continue to use ratings as part of the capital requirement determination.

For the reasons described above our high-level initial reaction to the options the Commission outlines is as follows:

Proposal 1 – require regulated and sophisticated investors to rely more on their own risk analysis for (relatively) large investments.

In principle we would support the greater use of firm's own risk analysis in the capital calculation for securitisation positions, in cases where more sophisticated systems and controls are in place. However, we do not think it

appropriate to apply the standards found elsewhere in the IRB approach to all investors in securitisation exposures. Such a move could put EU firms at a competitive disadvantage to their peers in third country jurisdictions and encourage the conditions for forced selling in what is already a fragile market; particularly if the alternative to internal ratings is deduction. Deduction is a disproportionate alternative for firms who did not meet such standards. Additionally any proposals to introduce an internal ratings approach for securitisation would be a significant change and should be considered as part of the wider review being undertaken by Basel of the securitisation capital charges. In the absence of detail on what such a proposal might mean in practice we reserve judgement on whether this would be an appropriate alternative to the current approach of using ratings. As noted above, we do not believe that ratings are entirely unsuitable for use within the capital calculation .

We are not aware that comitology provisions of this nature have been consulted upon and urge the Commission to follow better regulation principles and consult fully with stakeholders.

Proposal 2- Require that all published ratings include health warnings informing of the specific risks associated with the investments in these assets.

We do not think that it is appropriate to include health warnings on ratings. While there have been failings by the rating agencies, we do not agree that there is anything inherently unhealthy about them. In addition we are concerned that over-simplified health warnings might harm what is an already fragile market. Furthermore international initiatives aimed at improving the disclosure within ratings regarding risk factors are a more appropriate course of action.

We believe that investors require additional information on CRA methodologies and assumptions. Therefore, it would be more useful and appropriate for the Commission to focus on improving transparency of ratings methodologies. This should include which version of the methodology is used, risk factors, and assumptions specific to this transaction, among other factors. However, we do not support the proposal for the use of different rating scales for structured finance products. We are concerned that this proposal would undermine confidence in structured securities ratings by wrongly indicating that they are less stable than other types of debt securities. In addition, we are concerned that the introduction of new rating symbology will conflict with private investment mandates and guidelines. The proposal as it currently stands will impose unnecessary administrative burden and costs on market participants and ultimately will have a detrimental impact on both the US and EU economies.

Finally, it is important to note that Article 31 of MIFID already requires that firms disclose the risks associated with financial instruments.

Proposal 3 – Examine the regulatory references to CRA ratings and revisit them as necessary.

As regards the CRD we do not consider that further action is necessary to address the issue of over-reliance on ratings. In the absence of further detail on proposed changes, it is impossible to comment on whether changes in other Directives would be appropriate. However, as a general comment we highlight that initiatives centred on improving the quality of, and restoring and maintaining the confidence in, ratings are likely to be more effective, yield the greatest benefit to the market, and introduce the least cost and inefficiency.

ANNEX I: COMMENTARY ON SPECIFIC DRAFT LEGISLATION:

This section outlines our views on the detail of the draft Directive/Regulation:

Article 2 (14): Many CRAs have subsidiaries in different Member States in the EU. Each of these subsidiaries will often be a separate legal entity. The Commission should see the CRA as one entity across the EU and be regulated by a home regulator where the head office is located.

Article 3 (3): This article should be removed. It represents an extra territorial requirement and we do not see how the Commission could enforce it. Unless investment firms are banned from utilising ratings in any fashion from a CRA that does not have an office in the EU.

Article 5: The Commission should select objective and fair criteria for granting authorisation and assessing who should be the home regulator for a particular CRA, which must bear in mind the location, mind and management of the CRA group.

Article 7: It is not clear how competent authorities can verify whether the non-executive members of the administrative board or the members of the supervisory board are sufficiently experienced. This requirement is not consistent with the 4-year rotation requirement. It is not clear how those conflicting requirements are supposed to be complied with under the same directive.

Article 9 (3a): We do not support the restriction suggested in this article. It would seem to create odd incentives for firms to keep just below a certain revenue level. The industry does not consider that there is inherently a problem with a firm providing 5% or more of a CRA's revenue. A more effective approach that avoids undesirable impacts on users would be to allow CRAs to continue rating but require them to disclose information on clients that go over a certain revenue percentage. Users can then take a view on whether they wish to continue to use the ratings. Such an approach would be consistent with the IOSCO code.

Article 9 (4): This article should be removed. If implemented, rating agencies would not be able to charge for their research and ratings service, which are central to many firms' use of their expertise.

Article 9 (5): This article should be removed. Issuing structured finance ratings is, by its nature, an iterative process. Once a CRA has been engaged to provide a rating on a specific deal; it is vital that the CRA should be allowed to provide analysis on variants of structures put forward by the issuer. This does not constitute advice or consultancy. It is important that such dialogue continues to occur otherwise it will become very difficult for issuers to bring transactions to market in a timely manner.

Article 10 (4): We do not consider that this article is appropriate. An analyst working with a firm over a long period of time brings many benefits – a deep and holistic knowledge of the institution. This will only serve to benefit the quality of the rating. A four year limit will only serve to create a ceiling on the knowledge and expertise an individual can accumulate on an institution and will negatively impact on the rating process.

This idea is impracticable for other areas of ratings where analysts work with multiple firms on a regular basis (i.e. structured finance). We also consider that it is inappropriate for any regulatory agency to impose such a restriction on the day to day business of a regulated firm.

Article 11: This provision will be difficult to maintain for rating agencies and might contribute to churn in the industry. The market will clearly compensate individuals working in the most profitable areas more highly. As a result this will create an incentive to leave the rating agency and move to an investment firm.

Article 12 (1): Paragraph 3 (Due Diligence): Our members are particularly concerned about the language in Recital 12 and Article 12 regarding CRAs ensuring the quality of information used. This would fundamentally alter the business model of CRAs. It would require them to carry out forensic due diligence on all the information they receive, which is both technically very difficult as well as being inappropriate. There are already legal mechanisms in place to ensure the information supplied to the rating agency is of high quality. If, however, the Commission is determined to pursue this route, the following statement 'It shall ensure that the information it uses in assigning a credit rating is of sufficient quality to support a credible credit rating' should be amended to impose a 'reasonable steps' obligation rather than an unachievable obligation as at present.

Article 12 (5): This article is inappropriately prescriptive. The potential implication of requiring impact analysis and follow up for any minor change of approach could be to provide a disincentive to CRAs to develop valuable methodological changes because the burden of the consequences.

Article 13: This article should be deleted. It also seems to duplicate text elsewhere in the draft legislation. Requiring CRA's to refrain from rating complex products or those where there is less data would act as a drag on innovation, restrict access to information to investors at a point in time when more sources of information are beneficial and would be very difficult to supervise.

Article 19: There should be a clear delineation between 'home' and 'host' supervisors. This should work along the lines of the 'lead supervisor' model. There should be a clear delineation of powers and responsibilities for the home and host supervisors. It provides an opportunity for national regulators to potentially inappropriately influence a rating decision.

Article 21 & 22: The directive would grant substantive powers, not just to the Home Regulator, but to other Competent Authorities when they consider inaction or ineffective action by the Home Regulator. They provide further opportunities for regulators to potentially inappropriately influence ratings for national or political reasons. It would be a serious concern if other Competent Authorities are empowered to interfere into rating decisions, using supervisory issues as their reasons. Rating decisions are a business matter, and should be left to CRAs. It is unclear how to resolve situations where the home and host regulator have different views.

Periodic Disclosures 1 (a) & (b): The Commission should bear in mind that often ideas for structured finance deals are put forward to CRAs in draft form to see if they are likely to work. Often these proposals are in an early stage of development and represent 'early thinking' on behalf of the issuer. Just because these ideas are not taken forward does not imply anything untoward. The publication of such proposals would cut down on ideas being tested and have an unnecessary negative impact on firms' reputation.