Date: January 7th, 2011

To
European Commission
Directorate General Internal Market and Services
Financial Services Policy and Financial Markets
Securities Market

Reference: Public Consultation on Credit Rating Agencies

Dear Sir,

With reference to the public consultation on Credit Rating Agencies launched by your esteemed institution on November 5th, 2010, we are pleased to hereby provide the views of our association. But, first let us thank you for the launching of this public consultancy and the opportunity to comment. We do hope that you will receive substantial feed-back on the many aspects raised.

Our response addresses the five broad topics (Reliance on ratings, Sovereign Debt Ratings, Enhancing competition in the rating industry, Civil Liability, Alternatives to Issuer-Pays model). Before responding to your consultancy, please allow for a preliminary general comment.

Preliminary comment

Over the last couple of years and as a consequence of the financial crisis, new legislation covering Credit Rating Agencies was adopted in different jurisdictions. In Europe, the EU regulation on Credit Rating Agencies 1060/2009 ("CRA I") represented the first legislative step. Based on the public perception focusing on few global players, this regulation imposes substantial administrative costs to CRAs in order to manage conflict of interest without differentiation of the market segment nor the business model of the CRAs. The regulation is designed to cover primarily these few global players applying the issuer-pays model. The exemptions for smaller agencies based in the European Union (defined as having less than 50 employees) are limited and difficult to implement in the daily business.

The amendment of the EU Regulation on CRA in view of the establishment of the new European financial supervisory architecture was recently adopted in first reading in the European Parliament ("CRA II"). This new legislation introduces a robust supervisory scheme for CRAs in Europe assigning exclusive competences to the European Securities and Markets Authority ("ESMA"). In addition, it includes a detailed catalogue of possible fines and sanctions imposable on CRAs.

We are pleased that your consultancy covers a wide range of topics not addressed in legislative terms up to now, but which are present in the public debate. Your document outlines different options for different market segments, we therefore proceed from the assumption that your legislative proposal will also take a differentiated and balanced approach, taking into account the needs as well as the resources already available.

In the past, the legislative and regulatory frameworks have developed differently on a global basis, further fragmentising the framework for Credit rating agencies, agencies needing to cope with different requirements. These material legislative changes and the on-going legislative uncertainties is a key concern for CRAs and impede their further development. We therefore welcome more synchronisation of legal initiatives on a global basis. We also hope that your proposal will represent the last round of legislative proposals in the field of CRAs for the foreseeable future, as this will allow for legal certainty, drive investments into the industry and contribute to the goal of enhancing competition in the CRA market.

Reliance on ratings

Your consultancy addresses the perceived overreliance on ratings and proposes several alternatives and options. Before tackling your specific ideas, we would like to recall that the CRA Regulation clearly states that investors may use ratings for regulatory purposes. Already now, the use of external ratings is an option and not an obligation for these investors! Ratings are not meant to supplement risk assessments by institutional investors but should rather be used in parallel and as an additional source of information in order to make sound investment/lending decisions. Whereas several other players are active in the market (21 European players have requested registration as CRA by September 7th, 2010), the reliance steams from the focus on few global players. We therefore call on all European institutions to take into account all the registered CRAs in their respective fields of competences, thereby expanding the number of eligible ratings.

With respect to the proposal to limit the use of external ratings for the calculation of capital requirements (Question 1) exclusively to smaller/less sophisticated firms, we understand that the intention is to stimulate the use of internal models and processes for credit risk assessment, at least by larger credit and investment institutions. At the same time we consider that the definition of the smaller/less sophisticated firms is quite complex since not only dimensional factors should be considered but also a vast list of elements which characterize different business models: hence the practical application of these criteria may in some cases become highly subjective and cause not only confusion but also discrimination between firms.

Moreover the development and use of internal models and processes for credit risk assessment requires not only adequate expertise and resources, but also an adequate information base, which may be, at least temporarily, lacking even at larger institutions in specific market segments. In these circumstances the use of external ratings could be beneficial. Indeed, it is expected that the ratings issued by CRAs and/or ECAI will achieve the quality level expected so that any user (independently from their size, economic/financial strength or business model) will benefit from ratings.

With respect to your proposal to consider an exposure/issuer unrated unless two ratings are available (Question 3), we in principle welcome the proposal as several ratings provide additional insight into a risk. But we also consider that, from the pure practical point of view, this requirement, if applied to all issuers without distinction, imply that only in an extremely limited number of cases an exposure would be considered rated (currently, as a general rule, only the largest issuers have two or more ratings); furthermore, all the potential users of external credit ratings would be obliged to face additional expenses. De facto, this rule limits the space for new competitors in the credit rating sector.

So we think that a differentiated approach depending on the size of the issuer/issue and of the effective public availability of at least one rating should be used – this avoids excessive requirements on SMEs, who represent the backbone of the European economy.

Last but not least, if two (or more) ratings are available, both (all) ratings should be taking into account on an equal footing, without distinguishing for the underlying business model of the issuing CRA (e.g. unsolicited ratings are only the second option in some EU Member states).

In question 4 you ask whether market based risk measures could be used as alternatives to ratings. CDS spreads are incomparably more volatile than credit ratings as they may be driven by speculative funds and short term expectations (note that as a consequence of the financial crisis, accounting rules based on mark-to-market have been modified or suspended). Credit ratings are designed to be more stable over time in order to meet the requirements of long term investors (and the associated stability of the capital requirements).Moreover, market based risk measures are generally available for major issuers only; thus reliance on these measures would discriminate SMEs.

With respect to question 6 addressing "supervisory formulas" for risk assessment, we think that all players should have clear roles and functions. Supervising authorities should focus on their supervising function and credit rating agencies on accurately providing ratings. Through the set-up of specific rating standards by the supervising authorities, we see the risk that roles and functions would be mixed, which will not contribute to increase confidence in the ratings and may lead to substantial conflict of interest for the supervising authorities.
Increasing further transparency and disclosure by CRAs in order to allow investors to carry out their own due diligence is seen as alternative to reduce reliance on ratings. This policy approach, which is consistently applied in all fields of EU legislation, substantially increases the costs to all parties as investors need to treat themselves the whole set of information used in order to issue ratings. In addition, CRAs base their analysis a.o on public information (such as annual accounts for listed companies).

In order to reduce automatic reliance on ratings, you propose introducing a flexibility clause for investment managers (question 12). This would allow for investment managers to temporarily deviate from external ratings (eg for a period of 6 months) thereby allowing for a gradual sale of the corresponding asset and reducing volatility in the market. Such provisions are already used in some jurisdictions when ratings are used for regulatory purposes.
As to avoid credit ratings feeding directly back into a change in interest rate, we propose that references to specific ratings by a specific CRAs in bond/loan documentations should be avoided. Capital and Loan Markets participants should define on a case by case basis the primary risk metrics themselves (eg Debt to EBITDA levels defining interest rate margins), CRAs could monitor the compliance with the specified risk metrics and assign/adapt the rating independently.

Sovereign Debt Ratings

Ratings of Sovereigns has attracted much attention in recent months, whereby the rating actions (and their timing) of the few global agencies has been heavily criticized. Ratings issued by other rating agencies are widely not taken into account, whereas they may provide additional insight and rating actions may differ in terms of timing and assigned rating. We therefore call on all stakeholders to expand the number of recognized credit rating agencies in order to reduce reliance on rating actions by some few players. Having more agencies monitoring the developments of a Sovereign will ensure that investors will have an improved level of information and may be able to assess themselves the sovereign risk.

Although we agree that Sovereign Debt Ratings are primarily based on publicly available (question 11), the quality, depth and timing of this information might substantially differ from one country to another. In order to provide accurate ratings, this information must be treated by experts and ideally be clarified with government officials. Furthermore, as credit ratings are forward looking, it is important to receive information on long term plans of a government before them being in the public domain.

With respect to your proposals outlined on page 15 to 17 regarding the monitoring of ratings, we would like to state the following points:

- Having a three days periods for the Sovereign to review a rating action will create substantial conflict of interests for the Sovereign and will delay the information flow. In case of unsolicited ratings, such a provision creates not only high administrative expenses but ,more importantly, new conflict of interest to the CRAs may arise (which was not in contact with the Sovereign before the rating disclosure).
- Whether additional transparency on staff allocation is an argument to underpin a rating decision is doubtful. More than quantity, quality of analysis should be at the centre.
- Disclosure free of charge of the rating reports means that Rating agencies (especially under the unsolicited business model) will lack the financial incentive for covering sovereigns. Such a measure will substantially limit the number of players in this market segments, as only large players could afford delivering such ratings for free.
- Shortening the review period of Sovereign ratings is not a necessity as the current CRA regulation already requires a constant monitoring of ratings. We recommend rather that CRAs publish their timetable of regular updates so that all market participants are aware of the review.
- Enhancing the understanding of ratings by investors is an important measure we support as it contributes to the correct use of ratings. Making such conference mandatory for investors may seem excessive as investors may gather the required information and know-how through other channels.
- Given the global nature of financial markets, it remains doubtful whether the announcement of rating actions after the closure of European trading floors will substantially modify market behavior after a rating action.

<u>Enhancing competition in the Credit Rating industry</u>

On a global scale, the credit rating market is heavily concentrated in the hands of few players. These players achieve this high coverage as they are the only ones operating in all market segments in several countries. When looking at specific local markets, the picture may substantially differentiate as local players may have a high market share and excellent coverage. In order to enhance competition in the market and given that 24 rating agencies have requested registration under the EU regulation, the first requirement is to raise awareness within institutions, stakeholders and investors that alternative players exist. The European Commission could also act as a promoter of European CRAs and include all registered/certified CRAs as eligible in all EU guidelines and create incentives for the use of ratings issued by European CRAs. Finally, in order to tackle market dominance of few players, policies options learned from the lessons in other markets could also be applicable to the CRA market (e.g. SIFIs or audit companies).

The first tool in order to reach more competition in the market is to make the current regulation more effective and efficient. The core elements include the following topics:

- Disclosure requirement of unsolicited ratings: the requirement regarding the communication of the rating to the rated entities, has a strong impacts on costs and the timing of the rating activity but no real benefit to the investors using these ratings for internal benchmarking purposes. It creates new conflict of interest without providing a benefit to any involved party.

- Flexibility in terms of requirements on the agencies: even though the CRA Regulation foresees exemptions for small agencies, the scope of the exemptions is limited and the procedures hard to implement with a limited number of staff (e.g. separation of sales and analysis, independent review function).

The set up of a Public Rating Agency from scratch is a task requiring substantial (financial) efforts and time. It will not return any immediate effects as it will first need to built up all the required methodologies and staffing. In the medium term, the reputation of such a Public Agency will also be question-marked by investors even if independence is addressed.

The European Central Bank is a core institution of the European Union and can act independently in order to fulfill its key tasks in the monetary policy. Monetary policy is clearly a macro-economic function and responsibility, whereas credit rating relate to micro-economic issues. The mixed role of a Central Bank in terms of rating provider and Supervisor authority would create a possible conflict of interest and a strong disincentive to the usage of alternative providers (to the detriment to overall competition). The same logic applies to National Central banks.

We welcome the proposal regarding a Public Private Partnership between Credit Rating Agencies and the EU. The public side would benefit of the know-how, track record and resources on the side of the numerous CRAs. Although the scope and nature of an European Network of Rating Agencies is not outlined precisely, we proceed from the assumption that it is based on the principles of independence, cooperation and openness:

- Independence is core in order to ensure that agencies across all business model participate (e.g. solicited and unsolicited rating),
- Cooperation could be used in several fields: cooperation could be achieved in the context of cross-border analysis of cross-border companies or the development of European framework methodologies taking into account local specificities (such as different accounting standards);
- Openness: in order to ensure a wide reach, such a network should not be restricted only to small or medium rating agencies but should rather seek to involve in the medium term all agencies. This will ensure proper global coverage and therefore correspond to the global economic, financial and business environment.

In order to build up such a Network, public support and incentives are required. The CRAs, in the wake of the registration process under the EU regulation on CRAs, had to incur substantial administrative cost in order to met the requirements. At this stage, CRAs are not able to afford the costs of such a network by themselves.

Civil Liability

The last amendment of the EU regulation on CRAs in view of the establishment of ESMA includes a very detailed list of possible infringements of the regulation and the sanctions and fines can impose on the CRAs. We think that this catalogue of fines and sanctions represent already a comprehensive list and that additional Civil liability is not required. Such a Civil liability regime may substantially raise costs related to the issuance of ratings, thereby substantially increasing barriers to entry into the market as only large players could afford these additional costs.

Moreover it seems that the purpose of introducing a specific provision on civil liability in CRA Regulation is to prevent legal and regulatory arbitrage and improve legal certainty for investors. Although this purpose deserves consideration, it does not seem plausible to achieving a level playing field by introducing such a provision since its enforcement will fall within the competence of the courts of each Member State according to applicable national civil law. Therefore, major differences are going to remain de facto among the civil liability regime applied in the various jurisdictions.

A civil liability regime covering future events (e.g. the probability of default of an issuer) clearly needs to be rejected. Rating Agencies cannot be held accountable for the default of a specific issuer: ratings are a probability of default – even a highly rated entity may default!

Alternatives to the issuer pays model

At this stage, EACRA members follow different types of business models, as some operate under the issuer-pays models and other the user-pays model. The European Parliament in its draft report on “CRA’s: future perspective” acknowledges this differentiation as the “EP supports the existence of various payment models in the industry as long as inherent conflict of interest are addressed”. Furthermore, the EP “asks the Credit rating industry to come forward with proposals for alternatives viable payments models that involve both issuers and users”. We highly welcome this position and are prepared to contribute to the development of further payment models.

With respect to your different proposals, please find below our comments:

- Payment upon result model: as mentioned earlier, as ratings are assessments of credit quality and that issues having high ratings may also default, a deferral mechanism on fee’s will be hard to implement effectively. We instead propose that a CRA should be selected for the whole life of a debt instrument or cover a minimum period of 5 years.
- Public Government as hiring agent: in order to avoid long-lasting exclusive relationships with a specific agency, a rotation mechanism of CRAs should be envisaged. While selecting the agency, focus should not be on pure market share but should include local know-how and presence.
- Trading venue pays model: next to Equity ratings, we think that credit ratings with their medium term view are an useful information for all types of investors (including private sector) and should therefore be available. Given the public nature of these ratings, CRAs issuing such ratings would need to be compensated on a whole-sale basis directly by the stock exchange.

Let us thank you once more for the launching of this public consultancy. We do hope that you will receive substantial feed-back on the many aspects raised. Of course, we remain at your full disposal if you wish to clarify any comments from our side.

Sincerely yours

Thomas Missong President	Thomas Morgenstern Secretary General

About EACRA

The European Association of Credit Rating Agencies (“EACRA”), registered in Paris under the laws of France, has been formally established. The Members of the Association currently originate from 7 European countries and include the following companies:

- Assekurata Assekuranz Rating-Agentur is the first independent German rating agency that has specialized on the quality evaluation of insurance companies

- Axesor: Specialized on Spanish SME unsolicited ratings/scorings.
- Cerved Group: Italian Credit Rating Agency recognized ECAI by Bank of Italy
- Credit Rating: covers corporate, financial institutions and municipalities in Ukraine
- CRIF: global company that, in addition to the traditional services of information and scoring, started last year a professional activity aimed to issue unsolicited ratings to Italian companies
- JCR Eurasia: is Japan Credit Rating affiliated company in Turkey and covers all market segments.
- PSR RATING, based in Germany, focuses on solicited corporate ratings and the development of valid rating systems

The Members of the Association have very different business models while assigning ratings. All are deeply rooted in their respective markets, enjoy a high market share and a good reputation with local investors. In addition EACRA is in close contact with nearly all rating agencies in Europe.