CFA INSTITUTE | Centre for Financial Market Integrity

Carlo Comporti
The Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

London, 31st March 2008

Dear Mr. Comporti,

Response to CESR consultation paper
"The role of credit rating agencies in structured finance"

The CFA Institute Centre for Financial Market Integrity ("Centre") welcomes the opportunity to comment on the Committee of European Securities Supervisors' ("CESR") Consultation Paper - "The role of credit rating agencies in structured finance" (the "Consultation").

We support the evolution and development of structured finance products as new tools that have increased financial market efficiency. However we recognise that systemic failures have developed, primarily at the level of loan origination that the credit markets have been unable to quash or contain. An important element of the problem resides with the transference of risk from the loan originator to distant investors, who probably should have invested with greater care. The intermediaries of this process earned fees primarily for financial packaging rather than for their assessment of the quality of the underlying assets.

The Credit Rating Agencies ("CRAs") to some extent have had a part in the process that has lead to the current credit crisis. As paragraph 49 in the consultation points out, investors had come to misunderstand the purpose of ratings and begun to associate them with as the authoritative source defining price and liquidity. We feel that the CRAs could have done more to dispel this myth. We are also concerned that the ratings agencies relied too heavily on, and neglected to disclose the limitations of their statistical analysis. We sense that the direct contact of credit analysts with issuers in the construction of structured products creates a potential conflict that needs careful management. We also recognise that hesitancy in adopting procedures of best practice, and the delay to adopt the IOSCO standards in full have had a cumulative impact on how investors now view CRAs. CRAs provide an important service to the credit markets, and for that service to be valued in the future CRAs must take the lead in their own reform.

Earlier this year, the Centre reviewed the IOSCO Code and considered possible improvements to help make the ratings process more effective and enhance market perception of the ratings issued. In organising our suggestions, we drew on the resources of our 'Capital Markets Policy Council', a global voluntary group of market practitioners, who provide practical expertise and industry perspective to our advocacy work. Below is a

10th Floor, One Canada Square
Canary Wharf, London E14 5AB
United Kingdom

+44 (0)20 7531 0750
+44 (0)20 7531 0767
infoeu@cfainstitute.org
www.cfainstitute.org

list of some of the additional suggested reforms for CRAs that came from our review and analysis[1]:

- To use a rating nomenclature/categorization that distinguishes structured products from both corporate and commercial paper ratings to help investors recognize the differences.

- To refine or otherwise eliminate the concept of "investment grade" wherever possible to reduce the incidence of misconception about the purpose of the CRA's ratings.

- To encourage a global best practice of prohibiting the practice of "notching," where a CRA unilaterally issues a rating on an entity or structure that was not sought by the issuer.

- To create an executive-level compliance officer position at CRAs to ensure implementation and enforcement of the IOSCO code.

- To require complete adoption of the IOSCO code to claim compliance.

- To call on CRAs to refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating.

I attach our response that addresses the questions of the consultation paper. Please do not hesitate to contact me, should you wish to discuss any of the points raised in our response.

Yours faithfully,

Charles Cronin

Charles Cronin, CFA
Head, CFA Institute Centre
Europe, Middle East and Africa.

+44 (0)20 7531 0762
E-mail charles.cronin@cfainstitute.org

CC: Javier Ruiz, Director for Financial Information, CESR

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[1] The full press release is found at this link
http://www.cfainstitute.org/aboutus/press/release/08releases/20080205_02.html

The CFA Institute Centre[2] is part of CFA Institute[3]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of approximately 95,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom more than 81,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

Our detailed comments are set out as they are ordered by paragraph ("¶") number in your Consultation.

III.1. Transparency

¶ 80 - Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?

Yes. Whilst it is impossible to compel investors to do 'their homework'[4] we believe that prominent disclosure of the limitations of ratings and what they actually describe would be of value to investors. In addition, ***we are uncomfortable with the popular use of the phrase 'investment grade' and would like to see it removed as a term used by CRAs and discouraged throughout the industry***. While the original technical purpose of this term was to describe a credit rating that met the standard of creditworthiness needed for an institutional investor to buy the security, in popular usage the term has come to speak to the quality of the investment. This popular usage, therefore, has caused confusion and poor due diligence among certain investors.

¶ 90 - Do you agree with CESR's view that although there has been improvement in transparency of methodologies, the accessibility and content of this information for complex structured finance products requires further improvement in particular so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings?

Yes. Further information that is free to access from CRAs would be useful. One issue where there is a simple remedy is the removal of the registration feature, found on many CRA websites, which has to be completed before users can access technical information on methodology, standard assumptions and additional content. ¶ 85 in the Consultation mentions that underlying assumptions would not be freely available. We feel that in a

[2] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

[3] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

[4] See paragraph 49 of the Consultation.

highly concentrated market of CRAs that these assumptions should be free to view to enable investors assimilate important high level inputs with their own expectations.

We are also concerned that the ratings agencies are relying too heavily on and not disclosing the limitations of statistical analysis, for example the significance of statistical outputs, the stability of correlations, the sensitivity to changes in assumptions, or indeed the limitations of normal curve analysis. Because the cash flows of structured finance products are not comparable with 'regular' corporate debt, ***we believe it is imperative that CRAs assign a different rating nomenclature to structured finance products.***

§ 97 - Do you agree that there needs to be greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as rating reviews?

Yes, transparency and demonstration of consistent approach would help reassure the market. Disclosure of old and new assumptions and changes in methodologies are material pieces of information conveying valuable information to the market. There is also a clear case for highlighting the difference between ratings changes based on changes in methodology or from credit quality.

§ 100 - Do you agree that there needs to be greater public and standardised information on structured products in the EU? How would this best be achieved?

In principle we agree, particularly on the need to capture the performance of the underlying assets[5], but we feel this has its limitations. This is a specialist market; hence, we feel that segregation of the structured market from the corporate, via a change in nomenclature, is of primary importance to improving the process of price discovery. Greater transparency concerning the performance of the underlying assets, methodology and assumptions are highly valued but of secondary improvement in this discovery process.

III.2. Monitoring

§ 104 - Do you agree with CESR that contractually set public announcements on structured finance performance would not add sufficient value to the market to justify the cost and possible saturation of the market with non-material information?

Yes. The existing monitoring system appears to be adequate.

§ 112 - Do you agree that the monitoring of structured finance products presents significant challenges, and therefore should be a specific area of oversight going forward? Are there any particular steps that CRAs should take to ensure the timely monitoring of complex transactions?

[5] Please see CFA Institute Centre letter to the U.S. Securities and Exchange Commission regarding information requirements relating to asset-backed securities, at http://www.cfainstitute.org/centre/topics/pdf/CFA_Centre_-_SEC_ABS_04.pdf.

Yes. Monitoring presents significant challenges and specific oversight is important. We would support proposals that seek to separate analyst resources into two designated teams, one covering initial ratings and the other conducting ongoing surveillance.

III.3. Human Resources

¶ 118 - Do you believe that the CRAs have maintained sufficient human resource, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business?

We cannot comment on this question, as we not first hand consumers of CRA services.

¶ 120 - Do you consider that the generally unaltered educational and professional requirements of CRAs' recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

No, the basic ABS, CDO and CDS structures have been in place for over 10 years, despite product evolution, the underlying credit rating skills remain the same. In recent years demand for statisticians and senior mathematicians has significantly increased in structured finance. Of course, it is open to opinion whether these high-level skills add value in markets governed by human behaviour, which by its nature can be unpredictable. Hence, the broader market may discount these skills in the price discovery process. We draw to your attention to the fact that CFA Institute has at least 421 members working for CRAs, of which 369 are Charterholders[6]. The CFA programme[7] goes through regular practitioner refreshment cycles to insure that our 'candidate body of knowledge' equips newly qualified Charterholders with the knowledge they need to practice across the financial markets; this includes an understanding, valuation and application of structured finance products. The programme also provides a continuing education element that enables practitioners to maintain and update their skills and knowledge.

¶ 125 - Do you agree there is a need for greater transparency in terms of CRA resourcing?

Adequate human resources are a prerequisite for the efficient functioning of a CRA market. In an efficient market for CRA services, market forces would drive the best allocation of resources. We are mindful that four CRAs dominate this business. This has the semblance of an oligopolistic market, which could sustain sub-optimal resource allocation. We are uncertain that greater transparency under this market structure would do more to improve efficiency, as the ultimate users of credit ratings do not contribute to CRAs revenues.

¶ 126 - Do you agree with CESR that more clarity and greater independence is required for analyst remuneration at the CRAs?

CRAs react to market demand rather than create structured product business. There is potential for conflict of interest created by rating and fee income. It is encumbered on

[6] Members are not compelled to disclose the nature of their employment, those who do represent over 71% of the membership.
[7] The educational course behind the Chartered Financial Analyst (CFA) designation.

the CRA to resolves this potential conflict; more clarity and demonstrated independence of analyst remuneration from rating activity would serve the market's interest.

III.4. Conflicts of Interest

¶ 133 - Do you see the level of interaction between CRAs and issuers of structured finance products creating additional conflicts of interest for the CRAs to those outlined above? Do you believe that any of these conflicts are not managed properly?

Yes. We note that these interactions are two-way and non-public, which creates an opportunity for conflict that needs to be monitored.

¶ 134 - Do you agree that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers with regards to structured finance products and that there needs to be clearer definitions of acceptable practice?

Yes. Consumers of credit ratings would benefit from an understanding of these relationships and interactions. With regards the definitions of acceptable practice, the rating of structured finance products demands some type advisory input, that is an additional procedure to the traditional rating assignment, though according to the CRAs in ¶ 128 this is a purely passive process. These two elements of the structured finance rating process appear to be indivisible. While affirmations to observing tighter standards of best practice would be welcome, in practice monitoring for compliance would be very difficult, without stronger commitment and resources by CRAs. ***Therefore we believe that CRAs should commit to practicing all parts of the IOSCO code, and to the creation of an executive-level compliance officer position at each CRA. This compliance officer's duty would be to ensure implementation and enforcement of the IOSCO code, and to make sure that the CRA acts in a fiduciary manner with regard to protecting and promoting investor interests.***

¶ 138 - Do you believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business?

We would like to support CESRs' approach to this topic, but we feel it cannot progress due to the fundamental issue stated in ¶ 136 "CRAs... have also no public definition of what constitutes an ancillary service..." As stated in our answer above, the 'passive' advisory process is deeply intertwined within the structured finance ratings process. Therefore, we believe it would be difficult for ratings agencies and regulators to separate out ancillary services, apart from non-issuer facing revenues, from the structured finance rating process. Nevertheless, we believe more disclosure would alert investors to such potential conflicts of interest and allow them to make informed judgements about the independence of the rating process.

¶ 142 - Do you believe that the fee model used for structured finance products creates a conflict of interest for the CRAs? If yes, is this conflict of interest being managed appropriately by the CRAs?

No, but greater transparency could prevent conflicts from developing.

¶ 146 - Do you agree with CSER that there needs to be greater disclosure of fee structures and practices with particular regard to structured finance ratings so as to mitigate potential conflicts of interests?

Yes. Such information would alert investors to the potential conflicts of interest that are present in such structures and enable them to assess the degree of independence with which the ratings were assigned.

IV.2. The Regulatory Environment and Concluding Remarks

¶ 164 - Do you agree with CESR's view of the benefits and costs of the current regime?

A qualified yes. We would point out that the current organisation of CRAs is little more than an 'ad hoc' voluntary association brought into existence by the current disruption in the credit markets. Though there is the expression of commitment to the IOSCO framework, that commitment has been relatively weak. Our monograph "Self-Regulation in Today's Securities Markets[8]" discusses the elements that make for effective and ineffective self-regulatory structures. We feel that the CRAs ought to make a much stronger comment on the current and future regime.

¶ 170 - Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

Yes. We would add that formal regulation carries the additional risk that it could stifle the competitive health of the credit rating services market. Formal regulation lacks flexibility to adapt to changing circumstances and it lacks immediate access to industry knowledge from practitioners. Hence, we believe it is an inferior solution to formal regulation.

¶ 177 - Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation?

No. We believe there is a need for a more rigorous 'self-regulatory' regime, similar to the structure outline in Section E 'Compulsory Association by Law', in page 10 of our Self-Regulation monograph mentioned above; see quotes below.

> *"An organization with this level of regulation creates the standards that govern the members' activities and provides the mechanisms for investigating and sanctioning members for violations of these standards. ... Organizations of this type are motivated to self-regulate in order to ward off government intervention. To this end, they endeavor to maintain a high degree of public confidence by setting standards to promote the public good and establishing processes for monitoring the behavior of their members in order to detect problems that could undermine this goal".*

We would add that effective self-regulation has considerable advantages over government regulation, namely: flexibility, expertise, acceptance, higher standards and is conducive

[8] Please reference at this link http://www.cfapubs.org/toc/ccb/2007/2007/7

to a more competitive environment. A more detailed explanation is available on pages 5 and 6 of the same monograph.

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