

Ms. Kim Allen,
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

London, 24th April 2008

Dear Ms. Allen,

*Letter of 'Public Comment' responding to
"IOSCO Technical Committee Consultation Report on Credit Rating Agencies"*

The CFA Institute Centre for Financial Market Integrity ("Centre") welcomes the opportunity to comment on the International Organization of Securities Commissioners ("IOSCO") Consultation Paper - "IOSCO Technical Committee Consultation Report on Credit Rating Agencies" (the "Consultation"). We confirm that our comments may be made available to the public.

We feel that the consultation correctly analyses the role of credit rating agencies in structured finance markets. However, we are concerned that the ratings agencies relied too heavily on, and neglected to disclose the limitations of, their statistical analyses. We observe that many fixed-income portfolios are credit constrained and that the fiduciaries and regulators who set these constraints may not fully appreciate that a credit rating speaks to the probability of default and not to such issues as liquidity and volatility. This comment develops upon the consultation's remarks concerning the CRAs' activities in the shaping of structured products and the association made by some market participants that the eventual rating was a "seal of approval". We feel that the CRAs could have done more to dispel this myth through greater disclosure of their assumptions specifically about correlations.

In view of the points above, we strongly recommend that IOSCO, through the revised 'Code,' require CRAs to differentiate the nomenclature of structured products from traditional corporate bonds. The new provision in the Code makes this optional. We see a change in nomenclature as a vital part of the process to recognizing the differences between these different types of fixed-income instruments and help restore confidence to the credit markets and credit ratings business.

We are supportive of IOSCO's proposed revision of the 'Code of Conduct Fundamental for Credit Rating Agencies'. However, in a number of instances we would push for firmer measures. We highlight our belief that IOSCO should create a new principle asking CRAs to refrain from publishing ratings where they lack robust data and/or methodologies.

Our suggested improvements are based on a review of the Code earlier this year during which we considered possible ways to help make the ratings process more effective and enhance market perception of the ratings issued. In organising our suggestions, we drew on the collective experience and ideas 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 list of some of the additional suggested reforms for CRAs that came from our review and analysis¹:

- 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 “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,

A handwritten signature in black ink, appearing to read 'C Cronin'. The signature is fluid and cursive, with a small triangle mark above the final 'n'.

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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



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Your paper, published for information and comment, seeks comment on two statements.

1. Whether the paper correctly analyzes the role of credit rating agencies in structured finance markets.
2. To the proposed recommendations for modifying the IOSCO Code of Conduct Fundamental for Credit Rating Agencies.

Our detailed comments to these statements are set out below.

1. Whether the paper correctly analyzes the role of credit rating agencies in structured finance markets.

We concur with IOSCO's analysis of the role credit rating agencies play in structured finance markets. We highlight the following points that;

- The purpose of a credit rating is an opinion on either the likelihood of default or the potential for principal loss; it does not address market liquidity or volatility risk.
- The use of the term 'investment grade' causes confusion and we would discourage market participants using this term with respect to credit ratings.
- A CRA's opinion on the loss characteristics of a security is occasionally viewed by some market participants as a "seal of approval" on the investment, because in many respects the CRA controls the profile of the structure.
- With regards to methodologies we would go further and suggest that the CRAs should conduct their own relevance and reliability tests on the robustness of their

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 administering the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

methodologies and assumptions, for example in the case of default, recovery rates and correlations.⁴

- CRAs should ‘fully’ disclose the assumptions underlying their methodologies. We feel that in a highly concentrated market of CRAs that these assumptions should be free to view to enable investors to compare these important high-level inputs with their own expectations.
- Fixed-income portfolios are commonly asset constrained by a minimum credit-quality threshold. Whilst we agree that a credit rating speaks to the probability of default or likelihood of capital loss, trustees and other fiduciaries that set these portfolio constraints may not understand credit ratings in these terms. We have anecdotal evidence that customers pushed managers towards these structured vehicles because they offered higher returns than traditional corporate bonds. This behaviour is consistent with a manager selection process that is dominated by past performance.
- In view of the points above, which raise our concerns that a) the underlying methodologies ‘may’ have fundamental flaws, b) that assumptions ‘may’ push the bounds of mean-reverting behaviour, and c) that fund managers must respect the wishes of their clients, it is the Centre’s view that using the same nomenclature for structured products as traditional corporate bonds can create a “seal of approval” that leads to investor confusion. Therefore, we strongly recommend that CRAs should assign different rating terms and symbols for structured products.

2. To the proposed recommendations for modifying the IOSCO Code of Conduct Fundamental for Credit Rating Agencies.

We are supportive of IOSCO’s proposed revision of the Code of Conduct Fundamentals for Credit Rating Agencies. However, in a number of instances we would push for firmer measures.

- I. As mentioned above we are concerned that the CRAs have pushed the credibility of the mathematics behind their methodologies. Therefore, we urge that IOSCO include a new principle in the ‘Quality and Integrity of the Rating Process’ section of the Principles for the Activities of Credit Rating Agencies to assert better business practice:

“CRAs should refrain from publishing ratings where they lack robust data and/or methodologies.”

⁴ To quote Arturo Cifuentes of R.W. Pressprich & Co: “The three drivers in modelling CDOs are the probability of default, the recovery rate, and correlation of the underlying pool of credits. In general, the probability of default is by far the most relevant factor and correlation, the least. Unfortunately, an unwarranted amount of attention is currently given to correlation. Worst yet, most models are driven by (or based on) asset correlation assumptions when what is really relevant is the default correlation... Also keep in mind that a fair amount of what passes for sophisticated mathematical modelling (when it comes to this not-so-relevant variable) is often of very dubious legitimacy”.

- II. Returning to the 'Code of Conduct', we believe that due to modelling problems and associated "seal of approval" issues that CRAs must distinguish between traditional corporate bonds and structured products by using a different rating nomenclature. Whilst paragraph 3.5b, which discusses separate symbol disclosure on structured products is a step in the right direction, it offers CRAs a choice on whether to use a different nomenclature or not. This option has always been available to the CRAs, but to date has never been used on structured products, though now subject to discussion by the CRAs. Creating the provision will not drive change where the option has always been available. Hence we see a change in nomenclature as a vital part of the process in return confidence to the credit markets and credit ratings business.
- III. Code 2.5 which requests that a CRA separate its credit rating business from any other business, now requests that a CRA define what it considers and does not consider to be ancillary to its primary credit rating business. We are of the opinion that CRAs should not provide consulting or advisory services, to make a clean break from this potential business conflict.
- IV. We support the new code 2.17, the 'look-back' provision, which reviews the ratings of former employees who join an issuer or investment bank that the CRA currently or previously has rated. While we recognize that most rating agencies use rating committees to limit the influence of a single analyst, we believe these reviews are particularly important to ensure investor confidence. We also believe that these reviews should be extended to include instruments that have endured multi-step downgrades within a short period of time, such as three months. In either case, we suggest that the CRA should alert both regulators and investors about the outcome of such reviews.
- V. We support the new code 1.9-1, the provision that seeks to separate analytical teams into those that do the initial rating and those that subsequently monitor the rating. We would add that the members of these teams should go through periodic rotation, as a way of preventing abuses, or uncovering faulty ratings. This rotation of the rating teams will provide further oversight and management of potential conflicts of interest.
- VI. We would add in section B, 'Monitoring and Updating,' a code that CRAs should require analysts to participate in continuing education programmes on credit analysis, methodologies, and CRA policies and procedures.
- VII. Code 3.3 is amended to include public disclosure of methodology; this is a positive step. However we urge that CRAs should also disclose the 'assumptions' incorporated into these methodologies as part of this provision.
- VIII. We support new code 3.5c that seeks to increase public understanding of the rating process through increased disclosure. While we urge IOSCO to require CRAs to implement the Code in its entirety to claim compliance, we suggest that CRAs quantify the degree of compliance to this disclosure requirement if a comply-or-explain structure is retained.

- IX. An idea not discussed in this consultation, which we feel should be in the code, is that CRAs should cooperate to establish a centralized repository for ratings performance studies that is available to investors. The purpose of such a repository would be to allow easier market comparison among CRAs. This repository should be funded in such a manner by CRAs that will allow it to conduct its own 'public' studies into CRA performance free of interference by the CRAs.

24th April 2008