SJ – n° 2385/Div.

Ms Kim Allen
IOSCO General Secretariat
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Spain

23 April, 2008

Re: AFG (French Asset Management Association)'s comments regarding the IOSCO Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets

Dear Ms. Allen,

The Association Française de la Gestion financière (AFG)[1] would like to thank IOSCO for the work it has been carrying out on Credit Rating Agencies (CRAs) for several years now, and welcomes the opportunity to comment on this latest Consultation Report.

For your information, let us recall that AFG, a member of EFAMA, is also one of the 35 members of the International Investment Funds Association (IIFA) and actively contributes to building a reinforced dialogue between IIFA and IOSCO.

1. General Comments

As users of ratings, on behalf of third party investors, AFG members take particular attention to the current regulatory debate surrounding Credit Rating Agencies (CRAs).

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary financial portfolio managements. Our members include 405 management companies and 673 investment companies. These management companies are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing more than 2500 billion euros in the field of investment management, *making the French collective investment fund industry the leader in Europe* (with nearly 1500 billion euros managed, i.e. 21% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) *and the second at worldwide level after the US*. In the field of collective investment, our industry includes – besides UCITS – the employee savings scheme funds and products such as regulated hedge funds/funds of hedge funds, private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the International Investment Funds Association (IIFA).

Obviously, investment fund managers represented by AFG are responsible for the investment choices they make. But they need to rely on fair information, including ratings.

In our view, several areas probably require improvements, in order to ensure a better understanding of ratings by professional investors:

- The scope of risk covered – or not covered – by the ratings should be made clearer if possible
- A better methodology/symbology, as ratings should not be the same for very different types of financial instruments (e.g. corporate bonds as compared to structured financial instruments)
- Conflicts of interest must be avoided as far as possible, and otherwise clearly disclosed
- Regulators themselves are partly responsible for the over-reliance on ratings, when they introduced many regulatory references to ratings - giving therefore a regulatory status to ratings – without having probably thought enough on the unintended consequences of such regulatory actions. We wish to support here Recommendation 9, last paragraph; of the recent Joint Forum Report on Credit Risk Transfer, which states that "*supervisory authorities should review their use of credit ratings to determine if they need to clarify the distinction between corporate and structured finance ratings.*" More widely, in our view supervisory authorities should review the use of credit ratings in legislations/regulations.

It is difficult to conclude yet on the need, or not, for regulation or further regulation on CRAs. However, as a first step, and considering the recent troubles which surrounded ratings of Structured Finance Instruments (SFIs), we suggest both to reinforce some parts of the IOSCO Code of Conduct on the topics identified right above and to allow regulators for monitoring the compliance of CRAs with this reinforced Code in practice.

2. Specific Comments on IOSCO Consultation Report

a. *Regarding IOSCO Analysis of the role of CRAs in structured finance markets*:

We very widely agree on the analysis provided by IOSCO, in particular:

- the fact that credit ratings played a critical role in the building up of the "credit bubble" that led to the recent market turmoil
- that until recently, ratings did not address market liquidity or volatility risk
- that investors and regulators expect CRAs to take reasonable steps to ensure that the information they use is of sufficient quality to support a credible rating
- that many financial regulators rely on CRA ratings for regulatory purposes

b. *However, a few statements by IOSCO can be more arguable*:

We agree with IOSCO that from a ratings perspective it is not always easy to rate a corporate bond issuer (for which CRAs have to take into account market competition, managerial competence, etc.), while by contrast it seems easier to rate a SFI through underlying cash-flow projections which can be quantitatively modeled. But such an analysis also shows – and it is not so clearly stated by IOSCO - that although the basis taken into account for the two types of ratings is very different, it results in the same symbology –wrongfully for us.

c. *On the specific issue of Transparency and Market Perceptions*:

According to IOSCO, CRAs argue that coming up with a common metric to evaluate the performance of their ratings is not practical or desirable given the differing methodologies they employ. Still according to IOSCO, CRAs state that a common metric would push them towards a common methodology, which would deprive the marketplace of the varying approaches employed today. We support IOSCO conclusion that if the publication of ratings performance data is to have any meaningful use, the CRAs should endeavour to make it transparent and capable of some level of comparison. But we think another conclusion could be drawn: why push for a single symbology if the methods are not common from one CRA to another, and if the methods are not common from one type of security to another[2]? For instance the default rates appeared as different for different types of securities but resulted in the same ratings[3]. Considering the resulting confusion created recently in practice through the

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[2] For instance, two types of discrepancies hit in practice the meaning of ratings currently.

First, according to CRAs themselves, in theory the meaning of a rating is absolute, regardless of the relevant country, financial instrument, etc. E.g. one major CRA wrote in 2004: "*the comparability of these opinions holds regardless of the country of the issuer, industry, asset class or type of fixed-income debt*". Another major CRA wrote in 2007: "*our ratings represent a uniform measure of credit quality globally and across all types of debt instruments. In other words an 'AAA' rated corporate bond should exhibit the same degree of credit quality as an 'AAA' rated securitized issue*".

However, in practice, it appears that the actual behaviour of rated obligators or instruments may turn out to have more heterogeneity across countries, industries and product types (see for instance P. Nickell; W. Perraudin and S. Varotto, 2000, "*Stability of Rating Transitions*", Journal of Banking and Finance, 24, p. 203-227 – for evidence across countries of domicile and industries for corporate bond ratings. See also the Committee on the Global Financial System (CGFS), 2005, "*The Role of Ratings in Structured Finance: Issues and Implications*" – for differences between corporate bonds and structured products).

In particular regarding structured instruments, it appeared in the subprime turmoil that AAA ratings appeared less stable than normally expected for this class of assets, with examples of downgrades of several notches in a day.

Second, the rating agencies differ about what exactly is assessed. Whereas some major CRAs evaluate an obligor's overall capacity to meet its financial obligation, and hence is best through of as an estimate of probability of default, the assessment of another major CRA incorporates some judgement of recovery in the event of loss. The first ones measure what is called "PD" (i.e. Probability of Default") while the last one measures something which is closer to "EL" (i.e. Expected Loss") (see the analysis provided by the Basel Committee on Banking Supervision (BCBS), 1996, "*Amendment to the Capital Accord to Incorporate Market Risks*", Basel Committee Publication n°24).

In the specific case of structured products, one major CRA stated in 2007: "*we base our ratings framework on the likelihood of default rather than expected loss or loss given default. In other words, our ratings at the rated instrument level don't incorporate any analysis or opinion on post-default recovery prospects.*" By contrast, another major CRA incorporates some measure of expected recovery into their structured product ratings.

[3] For instance, according to Charles Calomiris (Henry Kaufman professor of financial institutions at Columbia University) and Joseph Mason (professor of finance at Drexel University), quoting Bloomberg Markets, while corporate bonds rated Baa by a CRA had an average 2.2 per cent default rate over five-year periods from 1983 to 2005, CDOs rated equally Baa by the same CRA had –before the recent crisis – an average five-year default rate of 24 per cent. We consider that delivering the same level of rating in the two cases (considering that the default

use of the same symbology for various types of securities, we would support the use of separate symbologies instead, for instance taking into account stress conditions regarding volatility and liquidity.

d. *On the specific issue of Independence and Avoidance of Conflicts of Interest*:

We agree with IOSCO that CRAs are doing more than rating structured finance securities, namely advising issuers on how to design the trust structures – presenting therefore a potential conflict of interest by nature.

e. *On the specific issue of Competition:*

We think it is probably one of the most difficult issue to solve. On the one hand the principle of enlarging the choice of CRAs is laudable. But on the other hand the wish to set up conditions for the activity of CRAs in issuing ratings limits by nature the number of eligible candidates, as it would make barriers to entry even higher than today.

f. *Regarding the draft modifications introduced in the IOSCO Code of Conduct Fundamentals for CRAs*:

We very widely agree with the amendments introduced by IOSCO in its Code of Conduct.

However, we have wonderings on the following provisions:

- Quality and Integrity of the Rating Process:

  Para. A.1.7-3: we obviously support IOSCO's request that CRAs should refrain from issuing a credit rating when the basis for such a rating would not be robust enough. CRAs must be organised to resist the potential risk of commercial pressure from issuers to get the issuance of a rating.

- CRA Responsibilities to The Investing Public and Issuers:

  - Para. A.3.5 letter b: IOSCO asks that the CRA should disclose <u>whether</u> it uses a separate set of symbols when rating SFIs, and their reasons for doing so or not doing so; the CRA should define and disclose a given rating symbol and apply it in a consistent manner for all types of securities to which that symbol is assigned. We think that having a *separate* set of symbols should be <u>a principle</u> as far as possible – for the reason mentioned above: if methodologies are different, rating symbology must be different as well. In addition, starting from such a principle, IOSCO should ask CRAs to apply a given rating symbol in the same manner, and not only in a "consistent" manner, for all securities to which this symbol is assigned
  - Para. A.3.8 last sentence: we agree on IOSCO intent to facilitate rating performance comparisons between different CRAs. But then in our view it raises the issue of remaining regulatory references to ratings, where the

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rate is clearly not the same in the two cases) might be misleading. *(see FT.com, "Reclaim power from the ratings agencies", 24 August 2007).*

potentially differentiated underlying basis for the ratings – from one CRA to another, or from one type of security to another – is not yet taken into account.

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If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), or Stéphane Janin, Head of International Affairs Division at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr).

Yours sincerely,

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