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AFG RESPONSE TO COMMISSION SERVICES WORKING DOCUMENT ON CREDIT RATING AGENCIES

The Association Française de la Gestion financière (AFG)¹ welcomes the opportunity given by the Commission services to express the French asset management industry point of view

¹ The Association Française de la Gestion financière (AFG)¹ represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 405 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing more than 2500 billion euros in the field of investment management, making in particular the French industry *the leader in Europe in terms of financial management location* for collective investments (with nearly 1500 billion euros managed, i.e. 22% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, *and second at worldwide level after the US*. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

related to credit rating agencies (CRAs). AFG is registered under the number **5975679180-97** in the European Commission's register of interest representatives.

First of all we want to stress that obviously asset owners and managers have their own responsibilities in taking investment decisions. Even if the UCITS Directive does not contain provisions which make reference to credit ratings, these ratings are very important for our business. Some funds have to invest only into best quality assets for example; it is especially the case for money market funds or bond funds. That's why rating is often a crucial criterion in the process of investment for fund managers when they have to assess the eligibility of financial instruments. A crucial criterion, but not the only one, because the UCITS Directive states rightly that fund managers must be able to rely on clear, fair and unbiased information when taking their investment decisions.

As mentioned explicitly and rightly by the Market Abuse Directive (although surprisingly the Market Abuse Directive was not referred to by the Commission in its consultative paper), the Credit Rating Agencies (CRAs) do not present investment recommendations as such, but give opinions on the creditworthiness of companies, including issuers of financial instruments or securities. As CRAs are granted access to inside information – *contrary to investment managers* - and since the credit rating has itself a substantial impact on the evaluation of an issuer or some securities, the CRA's rating assessment forms an important element in the investment research process.

Our members also have financial analysts and especially “credit analysts”. They elaborate their own credit risk assessment. It happens frequently, in our industry, that an analyst weights the risk of a company as being more important than the risk shown in the rating and so, prohibits any investment in the securities of the company in question.

As far as our national regulator already requires from management companies – as a condition to be authorised and to be kept authorised - the proof that:

- they can manage their funds professionally, i.e. with skilled people and adequate information systems;
- they act in the best interests of their clients;
- in the case of structured products, they have set up reinforced organisations with reinforced skills , risk management and information systems,

we believe that our members already comply with the *first proposal* of the European Commission services working document. So we hope the European Commission does not plan to impose new additional rules for UCITS, which are already highly regulated financial products.

Moreover, we want to underline that CESR recently published a new Consultation paper - Risk management principles for UCITS (Ref: CESR/08-616) – and we believe that **all issues concerning the management of (credit) risk by asset managers will be addressed in this framework, which we are currently examining, bearing in mind the necessary cost/benefit and also level playing field analysis.**

Second, regulators – and legislators – at national, European and international levels, have to think about their own responsibilities in the development of ratings in recent years, through the importance they have given to the ratings themselves (not only for structured finance instruments) in their relevant regulations and legislations. For instance regarding securitisation exposures in Basel II, the decision by legislators to reinforce the regulatory role of ratings obviously helped to develop the influence of such ratings. As this regulatory role of ratings has been increased by regulators and legislators, it pushed professional investors to use them more widely – with a consequent increased potential systemic risk.

That's why we fully support the *third proposal* of the European Commission to examine the regulatory references to CRA ratings and revisit – and eventually diminish or even delete - them. It is the only way to reduce undue reliance on external ratings, which was fostered in recent years by the excessive official role given by national, regional and international legislations to ratings. In any case, if references to ratings were to be kept in some regulations, it should be specified that it concerns ratings issued by properly authorised and supervised CRAs.

The *second proposal* is far more complex and of the utmost importance as it deals specifically with structured finance.

CRAs play a major role in structured finance. Without a rating and because structured finance is complex (and data are mostly confidential or difficult to find and to aggregate), investors would not find it easy or even possible to gather all appropriate information for two main reasons:

1. Originators can not always transmit all relevant personal information to third parties which are not subject to a confidentiality undertaking. In this case, CRAs act as an intermediary between the originator and market participants. Thus, ratings allow for reducing the asymmetry of information which structurally exists between CRAs and investors vis-à-vis originators;
2. Ratings are time-consuming and require large, skilled and full-time dedicated staff that can monitor *permanently* structured finance issues from the issuance until the legal maturity of the issues. As the largest CRAs have an international coverage and knowledge of various law and tax regimes, they are supposed to provide all market participants with a strong assessment of creditworthiness of transactions.

But at this stage, models and hypothesis are tailored by CRAs to measure the ability of the structure to fulfil its commitment to repay investors. CRAs evaluate an obligor's overall capacity to meet its financial obligation. Before the Subprime crisis, rating volatility was considered as lower for structured finance than for corporate bonds. It is clear that, after the crisis, the perception of rating stability is very different.

That's why we support the proposal of Commission services to include in ratings some specific information for risks linked to structured finance transactions.

We think that information should be in particular reinforced on:

- underlying portfolio components
- correlation components
- stringent justification on determination of the implicit volatilities taken into account for structured products embedding options, as today it is often difficult to understand the levels of implicit volatilities taken into account for the final pricing of structured products by issuers.

A particular attention should be drawn on changes in calculation methodologies. CRAs adapt their methodologies both to financial innovation and to new historic data and it is highly important for investors to know about the changes. CRAs have to inform more clearly market participants of such changes.

We also support the proposition of one of the largest CRAs to incorporate credit stability in rating calculation because of the high degree of credit volatility recently displayed by certain derivatives securities. Doing this, ratings will incorporate a more dynamic (and realistic) view

of credit risk including stress scenarios or so call “what-if scenarios analysis”. We think that this proposition could fit the Commission services proposal.

Finally, we would like to see the following information into rating reports:

1. An assessment of time-series used to calculate ratings which could include the number of observations, the volatility of observations, the different market conditions linked to the observations, etc.
2. A particular warning on the liquidity of structured credit issuances, as far as it is possible.

Note that even if we strongly support the Commission actions on CRAs themselves in order to improve their organisation and functioning within the EU, we have to avoid that regulation of ratings as such might lead to a too far-reaching standardisation in methodologies, which might result in a new risk: systemic risk.

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We thank the Commission very much for taking into consideration our comments and remain at your disposal for any further questions. Please feel free to contact myself at +33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), our Head of International Affairs Stéphane Janin at +33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr), or our Risk Management Senior Officer Bertrand Gibeau at +33 1 44 94 94 31 (e-mail: b.gibeau@afg.asso.fr).

Yours sincerely,

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