Date: May 7th, 2013

To:
Financial Stability Board
Via Email

Reference: **THEMATIC PEER REVIEW ON FSB PRINCIPLES FOR REDUCING RELIANCE ON CREDIT RATING AGENCY (CRA) RATINGS**

Dear Sir,

Reference the publication of the "Thematic peer review on the FSB Principles for Reducing Reliance on Credit Rating Agency (CRA) Ratings" on March 28th, 2013, we are pleased to hereby provide the views of our association (the short profiles of our members are annexed to this letter).

Whereas your peer review contains a detailed questionnaire for all different types of users, on which we expect your esteemed members to provide you with the necessary information, our response is structured differently to address first the general background for your peer review and address briefly current market structure. Thereafter we review alternatives to ratings and propose a short set of criteria to assess these. We proceed by providing some recommendations on references to ratings which are in line with your general principles. We for instance propose to amend the current wording of "remove or replace references to CRA ratings" to "Remove, adapt, complement or replace". Finally, given the global outreach of your institution, we have also included some recommendations regarding laws on credit rating agencies in order to support more competition in the market.

Background considerations

Since the start of the financial crisis of 2007/2008 (which spread from the US sub-prime market to European banks and thereafter to the on-going European sovereign debt crisis), mechanistic reliance on ratings has been identified as a source of concern, driving herd behavior, especially when associated with cliff effects. The herding behavior was amplified to a systemic global concern given that references to ratings on a global level related to only few players largely not being supervised.

The European Union introduced first legislation on Credit Rating Agencies in 2009, amended the legislation in 2010 to take into account the new Supervisory Framework in Europe with the establishment of ESMA as single European Supervisor on CRAs. The latest amendment of the regulation on Credit Rating Agencies (as adopted by the European Parliament[1] in January 2013 with expected entry into force by June 2013) as well as the recently agreed Capital Requirements directive for banks widely implement the Principles for Reducing Reliance on Credit Rating Agencies as published by your institution in October 2010 with regard to reference to ratings. Measures to increase competition in the rating market (to further reduce herding behavior) remain yet to be implemented.

Next to the European Union, several other jurisdictions have implemented new legislation on Credit Rating Agencies requiring the formal registration of credit rating agencies so that ratings may be used for regulatory purposes by different types of users. Our research on 75 jurisdictions (where competent authorities publish the registered players[2]) counts about 200 registered entities, breaking down to about 120 independent players (some of which already operate in several jurisdictions). These players have usually a very good coverage on their domestic market, sometimes limited to specific market segments only. All types of business models are represented, the issuer-pays model being just one of the different approaches.

The rating market in Europe is substantially developing, evidenced by a total number of 21 players registered or certified by ESMA currently (this number to increase as some applications are pending). Some players are in the process of extending their market, geographic or segment coverage – a change in market structure may be achievable over time if these sources of independent assessments are equally considered beyond their current domestic markets.

The recently published “European Financial Stability and Integration Report 2012”[3] dedicates one section to the “SME’s credit assessment industry, contribution to stability and growth”. The report indicates that SMEs in Europe face a growing need to find alternative sources of financing beyond the still pre-dominant bank funding, banks rebalancing their activities in wake of the increasing cost of capital associated with the introduction of Basel III. Whereas the report focuses on the credit scoring industry, it also indicates that European rating agencies are currently covering the European mid-caps whereas the global agencies cover the global companies (or about 0,3% of the total companies population of the surveyed countries). Some jurisdictions, such as India, have special registries of recognized rating agencies especially covering this market. Such a best practice of sizing requirements to specific markets may be beneficial to consider in order jurisdictions as well.

In more general terms, jurisdictions requesting mandatory ratings on publicly listed financial instruments have usually a more liquid market and therefore ensure easier/better access to funding. In some jurisdictions, in order to reduce reliance on one source of rating information

[1] The provisional text is directly available at the European Parliaments website: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-12

[2] Transparency standards by competent authorities varies substantially: while some publish an easily accessible separate list of registered ratings agencies (such as ESMA in Europe or the SEC’s OCR in the US), others allow only for the search of license, while several don’t publish such lists at all.

[3] See the European Commission’s website: http://ec.europa.eu/internal_market/economic_analysis/docs/efsir/130425_efsir-2012_en.pdf

only, at least two ratings are mandatory – the latest European legislation on CRA introduces such a requirement for the structured finance market.

On Alternatives to ratings

According to the Principle 1 on reducing reliance on CRA ratings in standards, laws and regulations, "references to CRA ratings should be removed or replaced only once alternative provisions in laws and regulations have been identified and can safely be implemented". The EU has adopted in Article 5ba of CRA III "Over-reliance on credit ratings in Union law" the goal of eliminating "all references to ratings in Union law by 1 January 2020, provided that appropriate alternatives to credit risk assessments have been identified and implemented".

In the US, the Dodd-Frank Wall Street Reform and Protection Act includes in its Title IX Subtitle C "improvements to the Regulation on Credit Rating Agencies" the removal of statutory references to credit ratings by replacing them by alternatives measures of creditworthiness. The US authorities have since then engaged in the exercise to find alternatives to ratings or to ratings related terms such as "high-quality assets" or "investment-grade". But the new definitions are sometimes vague (eg "an adequate capacity to meet financial commitments for the projected life of the asset or exposure") or sometimes relating to internal assessments of financial participants, thereby not providing a unique benchmark. Last but not least, some authorities (such as the OCC) still allow for the use of external ratings but should perform also a Due Dilligence themselves.

While searching for alternatives to ratings, the following criteria may be used to assess whether they provide the same comfort as CRA ratings: transparency, supervision, independence, meeting requirements of a variety of investors and issuers.

- **Transparency**: the EU regulation on CRAs sets a very high standard of transparency for CRAs. CRAs need to disclose publicly their rating methodologies and need to provide detailed ratings reports on rated entities (depending on the business model of the CRA, such reports are freely available or need to be bought). Users of ratings can therefore "track" and understand the CRAs assessment.
- **Supervision**: CRAs in Europe (and in most other jurisdictions having laws on CRAs) need to register and are supervised. The CRA Regulation on CRAs gives ESMA all means to sanction and penalize a CRA not complying with the requirements of the regulation (in ultimate ratio the registration may be withdrawn). This supervisory scheme gives to users of ratings a high level of comfort. Alternative measure need to be equally supervised in order to give the same comfort.
- **Independence**: the CRA III regulation in Europe further strengthens the requirements on independence of CRAs and the provisions regarding possible conflict of interests.
- **Serving all types of users and market segments**: by defining specific creditworthiness standards for different users and different market segments, costs to issuers, investors and supervisors are substantially increased as the "universal" language of ratings is being lost

- **Meeting requirements of long-term investors**, who look for more stability of the assessment over time.

Applying these criteria to alternatives of creditworthiness shows that none is able to meet all of them, such alternatives may even create new concerns:

- **Market measures** (such as market implied measures, CDS, but also mark-to market valuations): Although market based measures are easily tractable, due to their nature, they are based on short term expectations and subject to volatility. As a consequence of the financial crisis, accounting rules based on mark-to-market have been modified or suspended. Ratings are more stable and provide therefore for a more predictable basis for the calculation of capital requirements.
- **Usage of specific qualitative and quantitative credit risk measurement standards established by supervisory authorities**: Standards for risk assessment vary substantial depending on the market segment and the industry, as each has specific risk drivers and factors. Supervisory Authorities would therefore need to provide several new approaches. But, having the supervisor assessing an entity (for other external purposes) may create possible conflict of interest with the supervisory function. Additionally, Supervisory Authorities may be reluctant to publish their assessments on their supervised population in order to avoid any implicit/explicit “backing” of an entity.
- With respect the **Sovereign market**, some have proposed to use the Mimimum Country Risk Classification done under the umbrella of the OECD Arrangement on Officially supported Export Credit Agencies. Whereas we think that this Classification is highly interesting given the highly reputable participants undertaking this collaborative work, the participants do not rate the OECD High-Income countries and don’t publish detailed rating reports

Reference to ratings

In its opinion on CRA III (dated April 2012)[4], the European Central Bank stated that removing references to ratings may be difficult to apply or be disproportionate “since ratings constitute a valuable source of information and provide benchmarks (…) that the ESRB may use in the context of its tasks”.
in order to avoid mechanistic reliance on ratings and to increase competition in the market, we recommend that reference to ratings in laws, regulations, guidelines and technical standards should take into account the following considerations:

- **Use ratings in parallel to internal benchmark**: A common sense compromise between the exclusive relying on external ratings and, on the opposite, the deletion of any reference to external ratings is advocating their use in parallel with the own internal evaluations performed by the investors. Such approach would encourage both the development of more advanced instruments for the debtors evaluation by the

[4] The document is available at the European Central Bank website: http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2012_24_f_sign.pdf

investors and also the search for additional and alternative assessments in a market context where the evaluation of creditworthiness is often very complex and thus it becomes fundamental to dispose of qualified external benchmarks.

- **Avoid rating thresholds**: There is a difference between the existence of a rating and the level of the rating. Instead of rating thresholds, Regulatory Technical Standards from Supervisory Authorities should take into the existence of ratings and, if required, adapt the requirements to the level of the rating (eg similar to the standardized approach where risk-weights depend on the level of the rating). Minimum rating threshold, such as the ECB Collateral eligibility criteria, lead to group behavior in case of rating downgrades and are often drivers of the liquidity of an issue
- **Avoid rating related margins, avoid rating related collateral calls**: some financing agreements link the interest margin (or the collateral requirements) to the level of the rating, thereby creating a potentially pro-cyclical loop. We recommend that such references should be replaced by specific financial measures (or other covenants) agreed by the financing parties.
- **References to specific rating agencies should be avoided**[5] – references should be done to all registered players: some asset-management contracts include in their internal guidelines minimum rating levels by specific CRAs. Given the increasing number of registered agencies, such references should be replaced with the term registered CRA (and if required minimum rating levels should be replaced with corresponding credit quality steps.
- **provide for rules how to use ratings**: as rating agencies use different rating scales, a mapping of ratings to supervisory scales (eg in the European Union the 6 credit quality steps in the banking industry or the 7 credit quality steps under Solvency II) is recommended as this drives transparency and understanding. In case several ratings are available, provide for rules how several ratings can be used
- **promote the use of two ratings**: the EU has enacted a mandatory provision for the Structured Finance market . Additionally, the EU introduced a “complain and explain provision” requiring that issuer should consider mandating a small CRA (with less than 10% market share).
- **Proportionality**: smaller, less sophisticated players may not be able to internally rate specific issuers/issues. (eg a small local investment firm investing into new assets in other geographic area) and should therefore be allowed to use ratings. This principle has been included in the latest EU regulation on CRAs.

Whereas your Principles for Reducing Reliance on CRA Ratings frequently uses the “remove or replace CRA Ratings”, we therefore propose to expand these with “remove, adapt, complement or replace”:

[5] In its letter to the G20 dated April 15th, 2013, IOSCO mentions that “laws, regulations and private contracts referencing credit ratings sometimes recognize ratings issued by larger or regulated CRAs. This embedded use of ratings in laws and regulations could be a possible factor contributing to lower competition among CRAs” (source: http://www.iosco.org/library/briefing_notes/pdf/IOSCOBN01-13.pdf)

- **Adapt rules**: given the rapidly changing rating market, references to ratings should be generic and relating to all registered players
- **Complement rules**: instead of deleting reference to ratings, ratings could be used in parallel to other identified risk measures. For example, under the standardized approach, banks in the EU may use either the OECD Country Risk Classification or alternatively a sovereign rating issued by an rating agency. These two different assessments can currently not be combined.

Regulation on CRAs

As mentioned earlier, the herding behavior of investors was only possible given the current rating market structure, where the 3 largest agencies account for about 90% of the market. Next to the principle that investors should carry out their own risk assessment, investors should equally be mandated to consider all sources of risk assessment, including those of registered credit rating agencies. So called smaller credit rating agencies focusing on specific market segments or geographies have the ability to operate in such small niches only given their greater degree of specialization and the valued-added provided. In order to allow for more competition in the market, legislation on Credit Rating Agencies should therefore include the following important elements:

Take into account all types of business models: Whereas the "issuer-pays" business model as practiced by the global agencies is the most reknown, several other business models (such as the "investor-pays" but also special or mixed models) exist. Each rating agency adapts its business model according to the specific market they serve. Several studies show that diversity of business models have a positive effect on competition and financial stability, legislation on CRAs should therefore not impose a certain model.

Take a proportionate approach in regulation: similar to other financial legislation, where supervisory requirements depend on the size of the entity, requirements on CRAs should be differentiated. Under the EU legislation, CRAs may request according to Article 6 (3) to get some exemptions. Similar to G-SIFS's approach under Basel III, a special framework for systemic agencies may equally be beneficial.

Ensure transparency: in order to ensure the right use of ratings, supervisors should disclose on their website (easily accessible) the list of registered agencies. CRAs should disclose which of their activities fall under the regulation. Finally, a unique designation for registered CRAs (such as NRSRO in the US) is beneficial.

Ensure competition in the rating market: as CRAs need to obey to the highest standards in order to get registered, additional sectoral requirements for registered players should be avoided (eg for the structured finance market). Additionally, Central banks should align the list of eligible CRAs for collateral and monetary operations with the supervisors list.

Allow cross-jursidictional use of ratings from registered CRAs: At present, smaller EU CRAs are placed at an explicit competitive disadvantage as a direct consequence of EU

CRA legislation. Currently ratings issued in countries outside of the European Union, can be admitted for regulatory purposes through either endorsement or certification into the EU. The endorsement regime allows ESMA registered CRAs to apply for the ratings of affiliated companies based in one of 11 countries to be admitted for use in the EU. By contrast the certification process allows ratings issued by CRAs in four countries to be admitted for use in the EU without that CRA needing to have a physical presence in the EU. Unfortunately the EU approach is not reciprocated which is nonsensical[6] and is placing smaller CRAs at a significant competitive advantage to both non-EU CRAs and the big three rating agencies.

The situation is particularly perverse under the certification regime. For example, CRAs based in Japan are able to apply to have their ratings certified for use in the EU without having to establish a physical presence in the EU or having to submit to the full weight of ESMA regulation. By contrast there is no mechanism for EU CRAs to have their ratings accepted in Japan without establishing a physical office in that country and being subject to full regulation by the Japanese FSA. Japan is by no means unique in its approach [7]but it serves as a useful case study to illustrate that the point that the incoherent manner in which global CRA regulation is being applied is serving to severely restrict global competition. Potential competitors for the big three are being forced out of certain markets because they lack the scale to absorb the costs of establishing a global network of offices. The big three CRAs by contrast are better able to absorb these costs by virtue of their existing coverage. Greater international focus needs to be placed on creating a truly level playing field and as such there is a need for far greater co-operation between international authorities.

We remain at your full disposal if you wish to clarify any of the above or if we can be of any other assistance to you. Thanks again for the opportunity to provide your views!

Sincerely yours

Thomas Missong	Thomas Morgenstern
EACRA President	EACRA Secretary General

[6] In order to make the certification and endorsement mechanism operational, ESMA needs to enter into memorandum of understanding with the competent authorities in the respective country regarding cross-border supervision. Given that such MoU establish already a formal link across jurisdictions, why not applying them in both directions?

[7] Other jurisdictions requiring the establishment of an local office include amongst others Brazil, Mexico, Russia and Turkey.

About EACRA

The European Association of Credit Rating Agencies ("EACRA"), registered in Paris, was established in November 2009. The Members of the Association currently originate from 10 European countries and include the following companies:

A.M. Best Europe - Rating services Limited (AMBERS) is a subsidiary of A.M. Best Inc who have been providing ratings to the Insurance Sector since 1899. AMBERS' rating coverage includes regional, national and global insurers located throughout Europe, the Middle East and Africa.

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

Axesor: The first Spanish Rating agency registered with ESMA. Specialized in the middle market segment, with ample coverage of the Spanish corporate market.

Capital Intelligence (CI) offers independent rating opinions on financial institutions, corporates and governments in a wide range of countries, especially the emerging markets of Asia, Europe and the Middle East.

Cerved Group: Italian Credit Rating Agency recognized ECAI by Bank of Italy

Coface Services: French leader in business & marketing information and credit management solutions, providing a large range of tools to secure every step of companies' sales cycle and accompany their development

Creditreform Rating: based in Germany, a company of the Creditreform Group that is European market leader in the sector of business information was founded 2000 and is specialised in ratings of companies, bonds, funds and structured finance products across Europe..

CRIF: International Credit Rating Agency based in Italy providing both solicited and unsolicited Corporate ratings.

Fedafin AG : is registered with the Swiss Financial Markets Authority and acts as rating provider to the Swiss stock exchange

Informa D&B is the Marketing, Financial and Business Information leading company in Spain, offering currently more than 3.7 million online ratings on Spanish companies

Informa is the Marketing, Financial and Business Information leading company in Portugal, offering currently more than 820K online ratings on Portuguese companies

JCR Eurasia is an international credit rating institution based in Turkey.

National Rating Agency (NRA) is one of the leading independent rating agencies in Russia. As of today National Rating Agency has assigned ratings to over 750 leading Russian and international companies.

RusRating is a credit rating agency based in Moscow, with sister agencies in Armenia and Kazakhstan. It is accredited with the Ministry of Finance of the Russian Federation.

Scope was founded as an independent rating agency in Berlin, Germany, in 2002. The company is specialized in ratings and analysis of SMEs, bonds, certificates and funds across Europe.

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