ICSA
INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

April 25, 2008

Ms. Kim Allen
IOSCO General Secretariat
Calle Oquendo 12
28006 Madrid
Spain

Re: Comments on IOSCO's Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets

Dear Ms. Allen:

I am writing on behalf of the members of the Standing Committee on Regulatory Affairs of the International Council of Securities Associations ("ICSA") which is composed of the trade associations and self-regulatory associations active in the majority of the world's major securities markets.[1] We would like to thank the members of IOSCO's Task Force on Credit Rating Agencies for the work that they have done to produce *The Role of Credit Rating Agencies in Structured Finance Markets*, ("the Report"). We welcome the opportunity to comment on the Report.

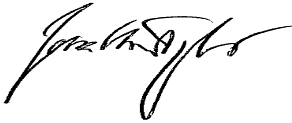
In general, ICSA members support the proposed changes to IOSCO's Code of Conduct for Credit Rating Agencies that are proposed in the Report. Credit rating agencies (CRAs) play an extremely important role in capital markets, and therefore it is critical that investors and regulators are confident in the work done by the CRAs. We agree with the analysis in the Report that the recent market turmoil and perceived weaknesses in ratings have given rise to legitimate concerns regarding the credit rating agencies, including concerns about their methodologies and potential conflicts of interest. We believe that the modifications suggested to IOSCO's Code of Conduct will, on the whole, contribute to a rebuilding of confidence in the CRAs.

[1] The members of the International Council of Securities Associations (ICSA) represent and/or regulate the overwhelming majority of the world's equity and fixed income markets. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members.

At the same time, although ICSA members support the vast majority of recommendations contained in the Report, there are some proposed additions to the Code of Conduct for Credit Rating Agencies that we find either too vague, and therefore in need of greater clarification, or which we do not agree with. Those specific sections are detailed in the Annex to this letter.

In closing, ICSA members would once again like to thank the members of IOSCO's Task Force on Credit Rating Agencies for their work in preparing the Report. We welcome the opportunity to comment on the Report and look forward to further discussing the issues contained in our letter with IOSCO members.

Sincerely,



Jonathan Taylor, Chairman,
ICSA Standing Committee on Regulatory Affairs
and Director General, London Investment
Banking Association (LIBA)

Annex: Specific Comments by ICSA's Standing Committee on Regulatory Affairs on IOSCO's Consultation Report regarding the Role of Credit Rating Agencies in Structured Finance Markets

I. Quality and Integrity of the Rating Process

1.7 *The CRA should adopt reasonable measures to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating.*

ICSA members are generally sympathetic to the notion that CRAs should ensure, to the greatest extent possible, that the data used for their analysis is of the highest quality possible. While, as drafted, the wording of this paragraph does not add significantly to the normal standards of care to which a CRA should be held, we are concerned that its inclusion carries with it an implication that CRAs would have a more onerous obligation imposed on them for structured products than for corporate credits and one with which it would be extremely difficult to comply. As is pointed out in the Report itself, CRAs "…traditionally do not confirm the accuracy of much of the information provided to them by issuers, who maintain ultimate responsibility for the accuracy of the information they provide to the market". We are therefore concerned that paragraph 1.7 could be taken to require the CRAs to assume the role of auditor of a structured product, with the attendant costs and legal uncertainties. We believe that the obligation for ensuring the quality of the data that the CRA's receive for purposes of rating structured finance products should continue to rest with the issuer, as is the case for the corporate and sovereign credits that the CRAs rate.

1.14-1 *A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.*

We would strongly urge the members of the IOSCO Task Force on Credit Rating Agencies to review the wording that they have used in this paragraph, since we ourselves are not really sure what it means.

For example, some members of the ICSA Standing Committee on Regulatory Affairs believe that paragraph 1.14-1 would essentially prohibit CRAs from providing advice on the structuring of a product and rating the same structured finance product. Other members of the Committee believe that paragraph 1.14-1 is meant to ensure that there are appropriate Chinese walls between the employees of a CRA that are involved in giving advice on structuring a given structured finance product and the employees of the CRA that are involved in rating that structured finance product. If the latter were the case, it would make the revised Code of Conduct for CRAs consistent with already established policies as

published by S& P and we are led to believe as followed by other leading other CRAs.

Moreover, paragraph 1.14-1 leaves unresolved a fundamental issue as to what constitutes advice. As the Report notes, the individual performing the ratings analysis for the CRA carries out a loss analysis to determine how much credit enhancement a given tranche security would need in order to get a particular credit rating. For that reason, as the Report also notes, the ratings process for a structured financial product differs significantly from the ratings process for a corporate bond since in a structured finance transaction, "… the CRA provides the investment bank with input into how a given rating could be achieved (i.e., through credit enhancements)."

The Report then also notes that:

> The serious question that has arisen is whether the current process for rating structured finance involves advise that is, in fact, an ancillary business operation which necessarily presents a conflict of interest. Conversely, while some observers believe that the structured finance rating process does not necessarily pose an inherent conflict of interest vis-à-vis the CRA's rating business more generally, the further question is whether a CRA has sufficient controls in place to minimize the likelihood that conflicts of interest will arise.

We agree that these are relevant considerations but, as noted above, we believe that paragraph 1.14-1 does not sufficiently clarify the issues and instead may add to the confusion.

Regarding how conflicts of interest within the CRAs should be addressed, some ICSA members would support paragraph 1.14-1 if the paragraph were meant to ensure that there were appropriate Chinese walls between the employees of a CRA that were involved in structuring a given structured finance product and the employees of the CRA that were involved in rating that structured finance product. Those associations believe that the CRAs are capable of maintaining sufficiently strong Chinese walls so that they could appropriately manage any conflict of interest that might arise if they were to both advise on and rate the same structured finance product.

On the other hand, some ICSA members would support paragraph 1.14-1 if it meant that CRAs would be prohibited from advising on the structuring of a given structured finance product and also rating that same product. Those associations believe that CRAs will not be able to appropriately manage the conflicts of interests that would arise if the CRAs were able to both advise on and rate the same structured finance products. Therefore, in order to restore the credibility of the credit rating agencies, they believe that it is necessary to ensure that individual CRAs are not able to advise on and rate the same structure finance products.

Regarding the definition of advice, many ICSA members believe that the process described in the Report, in which the ratings analyst is able to inform the sponsor regarding the rating that the structured finance product would receive – which in turn would allow the sponsor to adjust the structure if necessary in order to strengthen the rating – is separate from the advice that may be given at an earlier stage by other employees of the CRA that are involved in the structuring process. These ICSA members do not view feedback on rating scenarios as 'advising' but rather as providing facts on how the rating methodologies are being applied and on how specific changes in the structure would affect the ratings. If a prohibition were placed on the ratings analyst so that he or she could not inform the sponsor of the need for specific credit enhancements, these ICSA members are concerned that the result would be an expensive and time consuming delay in the entire process, as the sponsor would not find out that there was a need for additional credit enhancements until the ratings committee had reached their final decision.[2] In that case, there is a real risk that the process of rating structured finance products would become too costly and time consuming for sponsors. It could, as a result, effectively extinguish or severely limit the supply of new structured finance products with a senior investment grade rating.

Some ICSA members, on the other hand, believe that in order to ensure that conflicts of interest within CRAs are completely controlled there should be a complete prohibition on all conversations between the ratings analyst and the sponsor.

Given the potential implications of paragraph 1.14-1, we believe it is imperative that IOSCO clarify this provision.

3. CRA Responsibilities to the Investing Public and Issuers

3.5 b The CRA should disclose whether it uses a separate set of symbols when rating structured finance products, and their reasons for doing so or not doing so.

As it is written, paragraph 3.5b is not controversial as it would only require CRAs to disclose if they used or did not use a separate 'symbology' for the structured credit products that they rated compared to the corporate credits that they rated. However, the Report itself also states that, as part of the consultation process, "…the Technical Committee seeks public comment on the desirability of using a different set of rating symbols to differentiate structured finance ratings from ratings of corporate debt securities."

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[2] The situation would become even more complicated if the decision could only be given by a rating committee of a second CRA, which could not itself provide advice as to how to achieve a higher rating, which is one interpretation of 1.14-1. In that case, the stage would be set for passing the structure backwards and forwards between the two CRAs until the desired result were achieved.

In this specific area there is a difference of opinion among ICSA members. Some ICSA members believe that the CRAs should adopt separate 'symbols' for structured credit products compared to corporate credits because there is such a fundamental difference between a corporate or sovereign entity and the bundle of assets that lie beneath a structure finance products can behave. For example, a corporation has the ability to change its policies in response to a crisis, which in turn will affect its ability to service its debt. Indeed, part of the rating process for a corporate or sovereign entity includes an assessment of the quality of its management. The issuer of a structured finance product, on the other hand, even where the underlying portfolio is actively managed, generally has minimal ability to respond to a change in external circumstances.

On the other hand, a number of ICSA members argue that it would be inappropriate to adopt a separate 'symbology' for structured finance products. These associations do not believe that a separate notation would address the issues surrounding investor reliance on ratings, which appear to be at the heart of the authorities' concerns. A more appropriate response to that concern would be to improve the information that is provided to investors with the rating, for example by including information on the likely volatility of the rating and the factors that would influence that volatility. In addition some ICSA members believe that introducing a separate 'symbology' for structured credit products at the current time could further stigmatize those instruments at a time of low investor confident and highly illiquid markets. For example, in those jurisdictions which impose investment restrictions on certain institutional investors for securities below investment grade, it would call into question whether highly rated structured products under a new 'symbology' could continue to be invested in without limit. The result could be a further deterioration in credit markets, with consequent pass-through effects to the real economy.

Finally, we would note that the Financial Stability Forum (FSF) has recently recommended that credit rating agencies should differentiate their ratings on structured credit products from those on corporate credits. In addition, the FSF has also recommended that regulatory authorities should review their use of ratings in the regulatory and supervisory framework. Given these recommendations, some ICSA members believe that the fundamental regulatory issues underlying the use of ratings within the regulatory system should be resolved first, before any decision is made on the need for a separate set of ratings for structured credit products. Once that is accomplished, these ICSA members would suggest that the answer to the question regarding whether or not there should be a different 'symbology' for structured credit products would emerge naturally.