CHARLIE McCREEVY
MEMBER OF THE EUROPEAN COMMISSION

B-1049 BRUSSELS

16.09.2008 D/001812

Dear Lord Woolf,

Thank you for your letter of 10 September.

I have read with great interest your remarks on my services' consultation on Credit Rating Agencies (CRA). They are a very valuable contribution to our reflections on the way ahead. I shall be putting forward a proposal in this area in the coming weeks.

Yours sincerely,

Charlie McCreevy

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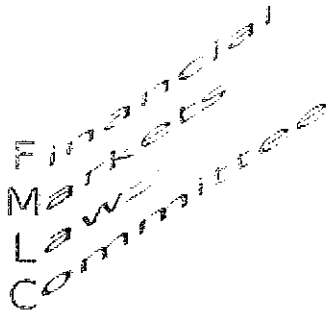

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10 September 2008

Commissioner McCreevy
European Commission
DG Markt Services
B-1049 Brussels
Belgium

Dear Mr McCreevy,

FINANCIAL MARKETS LAW COMMITTEE
ISSUE 139: Proposal for a Regulatory Framework for Crediting Rating Agencies

The remit of Financial Market Law Committee ("FMLC"), established and sponsored by the Bank of England, is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

It is from this perspective that I write to comment on the European Commission's consultation paper of 31 July 2008, which proposes draft legislation to govern the authorisation, operation, and supervision of Credit Rating Agencies ('CRAs' or 'the Agencies').

Introductory Remarks - Context

The FMLC is concerned that the consultation document issued by DG Markt reflects confusion about the role and responsibilities of CRAs. The paper strongly implies that CRAs were not only "close to the origin of the problems that have arisen in the professional structured credit markets" but were, in some way or part, responsible for those problems. The premise that a correlation exists between the unregulated activities of CRAs and the recent market turmoil is questionable and it is disappointing to find an assumption of this kind appearing without more at the start of a consultation document as a justification for a far-reaching policy initiative.

The FMLC believes it is important to clarify the nature of CRAs, their function is in the marketplace, the nature, scope and effect of their opinions as a reflection of the CRAs' internal processes and of market demand for their services. Without a sound basis in a detailed understanding of these aspects of the role and purpose of CRAs, regulation is likely to achieve little except to hamper the proper and efficient functioning of the Agencies.

In particular, it is important to bear in mind that a high credit rating is, in the context of issued securities, intended to be an opinion on the relative ability of the issuer to meet the financial commitments of the note. It is not intended to guarantee the market value of the issued securities in any way and, while the rating may depend on the market value of the underlying

assets, a high rating today is not intended to guarantee that those assets are proof against a future decline in market value or that market value triggers will not be breached.

A view which regards the CRAs as responsible for what is known, colloquially, as the credit crunch is likely to have overlooked these limitations on the responsibilities and objectives of the Agencies themselves. The credit crunch arose in part due to collective investor flight from certain markets and to the crystallisation of reputational risk as sponsor banks sought to protect the vehicles with which they were associated as a brand. Both these factors exacerbated difficult market conditions and made it difficult for structured finance vehicles and other issuers to fund long-term underlying assets. It is not clear that CRAs could or should have anticipated these problems or how they should have factored them into their assessment of the creditworthiness of the issuance.

If a misunderstanding as to the role and responsibilities of CRAs exists the disjunction between the perceived and actual circumstances in which they operate can only create uncertainty as to the application of the legislation devised in this context.

Substantive requirements to be respected by CRAs

The FMLC agrees that accurate and independent ratings are essential for the proper functioning of the financial markets and also that government cannot regulate for one or other content where investment ratings are concerned. Against this shared belief, the reference in the introductory remarks to "substantive requirements", which is not repeated in the draft legislation, is unfortunate. It would, perhaps, be better if the consultation document were to recognise consistently that any appropriate supervision of CRAs must be limited to imposing procedural and organisational requirements on the processes by which the Agencies arrive at a rating.

One of the foreseeable risks inherent in a regulatory project of this kind is that, directly or indirectly, the "vertical" imposition of new requirements and obligations will have a "horizontal" effect by vesting new rights of action in parties dealing with the regulated entities, or by substantiating existing rights of action in new ways. This risk is exacerbated where the legislation or regulation states that its purpose is to protect those who rely on the services or advice of the regulated entities. Recital (1) of the draft legislation put forward here by the European Commission seems to do this, particularly against the background of the remarks which introduce the proposal. This may lead to uncertainty about the extent to which the legislation is intended to have an impact on the ratings agencies' duties to those who use their ratings.[1]

A putative example of this kind of indirect "horizontal" effect can be borrowed from the Common Law: the tort of negligence could conceivably be substantiated by establishing standards of care for CRAs in legislation. That is, a failure to comply with those standards of care by a CRA could be prima facie evidence of a breach of a duty of care in relation to those who were proximately affected by the rating issued. In general, CRAs operating in Europe rely on disclaimers and exclusions of liability to avoid liability of this kind for negligent ratings. CRAs must rely on disclaimers of this sort because they do not have the advantage of statutory protections available in other jurisdictions which restrict their liability by excluding liability for any thing other than inaccurate or mistaken advice reflecting a reckless disregard for the truth. Typically, a disclaimer will specify that a particular rating is not a recommendation to purchase, sell or hold a security, inasmuch as it does not comment on the security's market price or its suitability for a particular investor, or the tax-exempt nature or taxability of any payments of any security. It will expressly state that the rating is an opinion, and is not a fact, and therefore cannot be described as 'accurate' or 'inaccurate'. In line with this approach, there is an established market consensus that ratings are opinions rather than

[1] The statement in Recital (1) that "those using credit ratings for their own investment decisions should take utmost care to perform own analysis and conduct due diligence regarding their reliance on such credit ratings" is helpful but does not go far enough in making it clear that ratings cannot be relied upon as an indication of an investment's suitability for a particular investor.

representations or recommendations and there is an established legal consensus in most if not all European jurisdictions that a disclaimer of this kind is effective. Since, a more onerous liability regime would undoubtedly undermine the viability of CRAs in their present form, it is important that any new legislation is expressed to conform to this consensus view and does not create uncertainty in this area.

Authorisation, supervision and enforcement

The FMLC is concerned that the proposed alternative regimes for the authorisation and supervision of CRAs ("Option 1" and "Option 2") are likely to prove very difficult to operate in practice given the truly international nature of what the Agencies actually do.

A rating may be commissioned through a local office in London, say, or Paris. However, it the process of arriving at that rating will probably not be effected, managed or overseen locally. Responsibility for the rating in question will lie with a Committee of experts who will be drawn, typically, from a variety of international jurisdictions and will remain in their home jurisdiction through out the process. The product of this process is, of course, the rating itself. This is not necessarily delivered to the commissioning client through the local office. The primary mode of delivery is publication: when the rating has been determined, it will be posted on the CRA's international website.

Whilst the FMLC would agree that "credit ratings are used by an indefinite number of possible addressees on [sic] the entire EU territory" it would argue that the wider geographical picture is also important: the same rating may be used by an indefinite number of possible addresses *globally*. This suggests that the imposition of regulatory and other substantive obligations on ratings agencies should be the subject of international co-ordination. (The draft directive is largely based on the IOSCO code. However, it by-passes the IOSCO proposal for an accession and enforcement mechanism to bind market participants.) Moreover, the corollary of an individual rating's international dissemination is that it is not always easy to identify a national regulator with a prior or dominant interest in the supervision of the relevant CRA.

In this context, the objective of the legislation to "create a one-stop-shop [authorisation and supervision] system for CRAs that wish to operate with in the EU" and to "avoid 'forum shopping' and the creation of a level playing field" is slightly opaque. This opacity is also a feature of Article 3(3) of the draft legislation which provides

> Credit rating agencies whose headquarters are located outside the Community shall establish a subsidiary or a branch in the Community for the purposes of performing the activity referred to in paragraph 1 [i.e. the issuance of credit ratings] and ask for an authorisation to operate in the Community through the subsidiary or branch.

It is unclear how a non-EU CRA that is allocating a rating, under the auspices of a Rating Committee established in a third country, to EU-issued securities and publishing that rating as an opinion on its international website can be required to establish a branch or seek authorisation in the EU. The problem is yet more apparent if the commissioning client is a non-EU entity, (perhaps one that is related to the EU issuer of the rated securities).

It seems conceivable that the market response to burdensome EU regulation will be to seek more cost-effective ratings which are processed in this way, outside the EU, in an effort to avoid the obligations which are being imposed by the (draft) legislation. It is unclear how the legislation could apply in these circumstances and if the industry does withdraw its visible EU operations, this could entail both the loss of a valuable market and the failure of the legislation to achieve its objective.

At a greater level of specificity, the international nature of CRAs activities renders difficult the concept of "home Member State competent authority" which appears throughout the draft legislation and the introductory remarks. The paper suggests that

> [t]he designation of the home Member State competent authority would be based on certain criteria related to the particular circumstances pertaining to the applicant's actual and planned activities, including the place where the applicant credit rating agency carries out or is planning to carry out the most important part or a significant part of its rating activity inside the Community. However other factors could also be considered...

This is not merely obscure because of the vague reference to indeterminate concepts such as "the most important part...", it may be wholly unworkable because the ratings activity may be evenly spread across a wide variety of jurisdictions as suggested above.

Equally concerning is the idea of the "involvement of other competent authorities", with or without coordination by CESR, and that "other competent authorities...[will not] lose their power of intervention". Leaving aside, for the moment, the lack of clarity inherent in the phrase "acting within its territory", which is the trigger, in Article 22, for another competent authority to act against a CRA, the mere idea of overlapping multilateral action by various national regulators is problematic from a market stability perspective. It is not difficult to imagine a situation where a very large number of EU national regulatory authorities believe that intervention is warranted in relation to a particular rating of widely-purchased securities because of "problems related to the use of a rating...". That multilateral intervention might take the form of conflicting instructions to the CRA in relation to disclosure and reporting, or even to the withdrawal of a particular rating (as contemplated by Articles 9 and 13). It is doubtful whether any overarching or collegiate body would be able to coordinate this multilateral intervention with sufficient ease and efficiency to prevent disruption to the relevant securities, and even possibly to the market, in these circumstances.

Conclusion - Further Comments

As a general point, the FMLC is concerned that the consultation paper implies a misunderstanding of what CRAs actually do, as discussed above, and the international nature of their processes. The FMLC is also troubled by the fact that there does not appear to have been any international consultation on this matter. Bearing in mind the wider ramifications of the proposal, and the fact that the financial services industry is global, this is a serious shortcoming.

A further significant lacuna in the proposal is that there is little or no discussion of how the draft legislation will fit in with existing EU legislation which specifies a regulatory role for credit ratings, e.g. the Capital Requirements Directive[2]. For example, if a credit agency breaches the specified organisational requirements and operating conditions in arriving at a rating, will that rating be nonetheless effective for other regulatory purposes under European law; or not?

In the FMLC's view, these omissions great a area of legal uncertainty which may fundamentally undermine the suggested proposals.

In Articles 9 and 13, the draft legislation suggests that CRAs may be required to withdraw existing ratings in certain circumstances. Should this occur, this will usually force asset managers, whose activities are subject to the restrictions set out in their investment management agreements, to sell the financial instruments in question until the status of the rating is clarified. This would almost certainly cause the very market instability which the paper is expressly aimed at avoiding if it were to occur on any significant scale across the market. It is not clear from the consultation paper whether adequate thought has been given to this.

In addition to those mentioned above and the sections which will be drafted when a supervisory architecture has been settled, there are further areas where clarification is required in the draft legislation, specifically: the use in Article 7 of such a vague standards as

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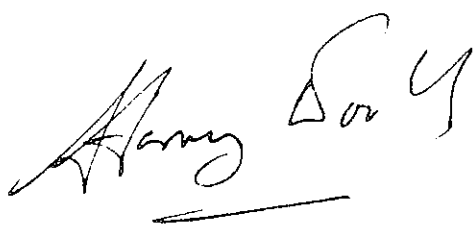
[2] Directive 2006/48/EEC (the restated Banking Consolidation Directive) and 2006/49/EEC (the revised Capital Adequacy Directive) together generally referred to as the Capital Requirements Directive.

'of good repute and sufficiently experienced' in relation to the directors of a CRA and, in Article 12, the rather opaque concept of "ratings that may be subject to validation based on historical experience".

The FMLC would welcome the opportunity to discuss these issues further with you if that would be helpful.

Yours sincerely



Lord Woolf

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