



October 25th, 2010

To  
Department of the Treasury  
Office of the Comptroller of the Currency

Federal Reserve System

Federal Deposit Insurance Corporation

Department of the Treasury  
Office of Thrift Supervision

Reference: Public Comment on Advance Notice of Proposed Rulemaking Regarding Alternatives in the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies

Dear Sir,

First of all, we would like to thank you for the opportunity to provide comments on this Proposed Rulemaking regarding Alternatives in the Use of Credit Ratings. Given that in the past US proposals tended to spill over to Europe and other regions, we are pleased to provide here our views on this consultancy. In the past, the legislative and regulatory frameworks have developed differently on a global basis, further fragmentising the framework for Credit rating agencies ("CRA"), agencies needing to cope with different requirements. These material legislative changes and the on-going legislative uncertainties is a key concern for CRA and impede the further development of CRAs. We therefore welcome more synchronisation of legal initiatives in the US and Europe as announced by the European side recently.

With reference to Question 1 regarding the guiding principles for the formulation of credit-worthiness standards, we propose including that such assessment should be carried out on an independent basis, without taking into account other business opportunities or additional fee's. In order to foster prudent risk management as proposed by your institutions and given that the credit assessment is an integral part of the pricing of a security or lending instrument, we recommend adding this independence principle.

Although we agree that a credit assessment should "be sufficiently transparent, replicable and defined", we don't agree with your conclusion that "banking organizations arrive at the same assessments of credit-worthiness". Beyond pure quantitative elements, credit analysis takes into account qualitative aspects, which are harder to measure "objectively". Credit analysis is therefore based on an expert analysis (as opposed to pure scoring methods); two assessors of credit worthiness may have different final assessments of the same entity, putting more emphasis on one aspect or the other. Having various credit assessments by different independent parties will benefit to investors, as each assessor might highlight different risk aspects.

On Page 9 of the Consultancy, you propose the following alternatives to the use of ratings:

- 1) Delete all of the sections in the risk-based capital regulation that refer to credit ratings and retain the remainder of the general risk-based capital rules
- 2) Usage of specific qualitative and quantitative credit risk measurement standards established by the Agencies
- 3) Usage of market based measures

**European Association of Credit Rating Agencies**

84, Avenue de la République, 75011 Paris, France

Registered under French directory of Association N° W751202513

[www.eacra.eu](http://www.eacra.eu)

Page **1**





- 4) Assignment of risk weight based on assessment of the exposure's probability of default or expected loss.

We would like to bring to your attention the following remarks.

Ad 1) From a European perspective, where Basel II has been implemented by financial institutions, deleting any reference to Credit Ratings would represent a step backwards. We would rather propose to smooth the risk-weights into more subcategories in order to reduce sudden changes in capital requirements following a rating action.

In addition, we would propose tackling the so-called "cliff-effect" at certain rating categories. Under the EU Regulation on CRA, investors *may* use rating for regulatory purposes. Ratings are therefore an option but not an obligation. In case of a rating downgrade below the cliff, trading on the specific issues should be suspended for one day, during which investors may decide to follow the decision of the rating agency and whether they should sell the issue concerned. Such a mechanism would avoid sudden market disruption as a consequence of a rating action.

Ad 2) Standards for risk assessment vary substantially depending on the market segment and the industry, as each has specific risk drivers and factors. Under EU regulation, rating agencies need to use "rating methodologies that are rigorous, systematic, continuous and subject to validation" (Article 8.3). CESR, the Committee of European Securities Regulators in its guidance dated August 30<sup>th</sup> states that it will not interfere in its content. As the rating agencies need to prove the discriminatory power of their methodologies, the focus of the regulation is rather that the methodologies are applied systematically by the agencies. Such an approach allows for a diversity of rating methodologies (for different industries), reflecting different ways of tackling the same concern.

From an institutional perspective, we think that players should have clear roles and functions. Supervising authorities should focus on their supervising function and credit rating agencies on accurately providing ratings on their methods. Through the set-up of specific rating standards by the supervising authorities, we see the risk that roles and functions would be mixed, which will not contribute to increase confidence in the ratings.

Finally, setting the standards by the supervisors, means that no innovation at the level of the rating agencies is expected. In times of new financial products, agencies would not be able to rate such issues as long as a framework is not provided.

Ad 3) 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.

Ad 4) As ratings include the analysis of probability of default and/or expected loss, assigned ratings can be easily transposed as rating notches correspond (in theory) to a certain level of probability of default. We would propose the introduction of an additional rating scale, based on which CRA would need to disclose their ratings. In addition, we propose that CRA's should assign two ratings: the pure quantitative rating and the final rating – the gap between the two representing the qualitative impact. These two measures will allow for better comparability of ratings and increase transparency.

On Sovereign Ratings (Question 3)

One of the options considered is assigning Sovereign ratings based on the formal membership in an organization. Such an approach has the advantage of being highly discriminatory and easily tractable, but would not allow for the distinction in the underlying credit quality of a Sovereign. In addition, the





simple fact of a membership in an international organization is not necessarily security that a country could not default.

Currently, several rating agencies and multinational organizations carry out country reviews and country assessment, each based on their experience, know-how and methodologies. We therefore propose that the overall Sovereign rating should take into account all these views (eg by taking the average of the ratings). Such an approach would reduce reliance on the ratings (and rating actions) of one or few players (without endangering the diversity of ratings) and would lead to a constant review/monitoring of the rating by several institutions.

The other questions you raise relate to specific market segments (Public Sector, Bank Exposures, Corporate Exposures, Securitization Exposures), options available being essentially the same as those discussed above. We therefore refrain from commenting these items again and would rather like to restate the following items:

- The European legislation on CRA's provide for an option to investors to use ratings for regulatory purposes. As it is not obligation, the risk of over-reliance on ratings is already reduced
- Supervisors should oversee the activity of CRA's and should have the possibility to sanction CRA's not fulfilling all requirements (such sanctions could include as ultima ratio the withdrawal of the registration). The on-going revision of the CRA regulation in Europe introduces such an Annex of detailed sanctions, competent authorities will therefore have the means to act.

Sincerely yours

Thomas Missong  
President

#### **About EACRA**

The European Association of Credit Rating Agencies ("EACRA"), registered in Paris under the laws of France, has been formally established. The Members of the Association currently originate from 7 European countries and include the following companies:

- Assekurata Assekuranz Rating-Agentur is the first independent German rating agency that has specialized on the quality evaluation of insurance companies
- Axesor: Specialized on Spanish SME unsolicited ratings/scorings.
- Credit Rating: covers corporate, financial institutions and municipalities in Ukraine
- CRIF is a global company which supports and creates value for financial institutions, businesses and consumers in providing information and assessing credit risk. In the last year, CRIF has developed a service which assess and give a rating to SMEs compliant with the EU Regulation of Credit Rating Agency.
- JCR Eurasia: is Japan Credit Rating affiliated company in Turkey and covers all market segments.
- PSR RATING, based in Germany, focuses on solicited corporate ratings and the development of valid rating systems

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. In addition EACRA is in close contact with nearly all rating agencies in Europe.