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Dear Mr Demarigny

Response to CESR's Questionnaire regarding the rating of structured finance instruments

Introduction

The European Securitisation Forum[1] (ESF) and the Securities Industry and Financial Markets Association[2] (SIFMA) welcome this opportunity to respond to the Committee of European Securities Regulators (CESR) questionnaire regarding the rating of structured finance instruments. The ESF response is focused on the second part of the questionnaire addressed to all market participants.

The ESF generally defines structured finance instruments as transactions by which a securitisation or any other risk transfer undertaking (typically a special purpose vehicle – SPV, but not in all circumstances as described below) acquires or assumes directly or through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or inherent to all or part of the activities of third parties and issues securities,

[1] The ESF is the voice of the securitisation and CDO market place in Europe, with the purpose of promoting efficient growth and continued development of securitisation throughout Europe. Its membership is comprised of over one hundred and sixty institutions involved with all aspects of the securitisation and CDO business, including issuers, investors, arrangers, rating agencies, legal and accounting advisors, stock exchanges, trustees, IT service providers and others. (Note however that our CRA members will be responding separately to Part 1 of the Questionnaire). The ESF is affiliated with the Securities Industry and Financial Markets Association (SIFMA). The ESF has two sister organisations: the American Securitization Forum and the Asia Pacific Securitisation Association. SIFMA has been actively involved in previous IOSCO and CESR consultations and questionnaires on the topic of rating agencies.

[2] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in London, New York and Washington D.C., and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

whose value or yield depends on such risks[3]. These instruments are generally categorised in broad asset classes including residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), consumer and corporate asset-backed securities (ABS), collateralised debt obligations (CDO), whole business securitisations (WBS). However, our comments also apply to SPVs and/or relevant bank issuance programmes which create fixed income structured products (e.g. Structured MTNs, repackagings, synthetic CDOs (including structured credit trading (SCT)) in relation to which all or part of the cashflows may mirror or be referenced to cashflows generated by underlying derivative or other products.

Please note that our comments are relevant only in the European context and do not address any non-European market considerations, such as US subprime.

Responses to the CESR questions

Rating process

1. Do you consider that access to and availability of structured finance ratings (and any subsequent changes) is satisfactory?

Broadly yes. Overall the importance of structured finance ratings has increased significantly following the implementation of the Capital Requirements Directive (CRD) and will have also an important role in the Solvency II Directive. The dissemination of ratings information takes place through several various channels including websites of the CRAs, issuers, data providers, data vendors and stock exchanges. The CRAs understand that the timely dissemination of ratings and subsequent changes is very important for market confidence and the CRA's reputation. Ratings generally must be good predictors of probability of default or expected loss, and thus remain meaningful for market participants, and structured finance ratings in particular help minimize risks to the market because of the potential impact of rating changes on the valuation of securities. The timing of the updates may vary depending on the type/complexity of deals and underlying asset composition and analysis in the various European jurisdictions.

2. Are you satisfied with the credit rating agencies (CRAs) disclosures on their fees policy?

Whilst we would welcome greater transparency on the CRAs' part in terms of fees disclosure, we believe that it is a commercial issue best left to relevant parties to negotiate. Although on many products each CRA has a standard fee scale that is openly disclosed, in many circumstances the actual fee will reflect the characteristics of the transaction including its structure, complexity and

[3] This definition is derived from the securitisation law of Luxemburg, title I, article 1 (1).

innovation compared to similar deals. This variability of fees in the structured finance industry is a function of the amount of CRA staff time required to analyse the transaction, as well as deal size, complexity and whether the issuer is a first-time or rather frequent/repeat issuer. For example, a CRA's fees may represent a greater proportion of the overall transaction costs for deals from a new issuer or in a new jurisdiction or for deals with highly innovative features.

Rating methodologies

3. What are your views on the fact that the agencies use different analytical models to assess the portfolio credit risk? Are you satisfied with the way the rating agencies assess such risk?

We welcome the use of different analytical models for various types of transactions, so that each individual rating is based on a transaction-specific set of portfolio and structure assumptions. Generally, the models for CDO transactions are all publicly available from the CRA websites. This is done in order to maximise transparency of the ratings methodology for this relatively complex transaction type, for which portfolio characteristics can change considerably over time based on the actions of a CDO manager as well as pool performance. The models for non-CDO transactions may or not be publicly available, depending on the complexity and uniqueness of each transaction. It is important to note that models, even if very advanced, are based on a number of assumptions, not all of which are easily quantifiable. These assumptions can also vary quite substantially among CRAs. These assumptions are usually based on historical experience, as well as the CRA's judgment as to future trends, particularly if there is little historical experience for a particular asset class. If the actual performance of a pool later differs materially from the original assumptions made when the deal was rated, it is likely that the transaction could be downgraded or upgraded. Unlike corporate or government ratings, structured finance ratings reflect an opinion regarding a specific portfolio, single asset or liability risk as well as specific structure (e.g. transaction-specific cash flow allocation sequence or priority of payments if certain events occur). We encourage the CRAs to continue improving the modeling of new and derivative products while at the same time encouraging investors to continue improving their internal risk management capabilities. As with corporate and government ratings, CRAs are being much more consultative of the marketplace in relation to proposed introduction of new, or changes to existing methodologies, thus providing enhanced transparency and predictability on credit ratings and rating actions.

It is important to note that the CRAs' structured finance ratings only address the probability of default and/or expected loss (depending on the specific CRA) and do not address the likelihood of future rating actions, stability of ratings or secondary market price. For example, a mortgage pool could experience worse-than-expected credit performance that could materially affect the secondary market price, but might not necessarily cause a ratings downgrade on all tranches since that poor performance may have been factored into the stress scenarios reviewed at the time of the original ratings. For CDOs, if the credit quality of a pool changes suddenly and if the pool is not particularly granular (e.g. a relatively small number of different names), the ratings could be more volatile than for more granular pools.

4. Are you satisfied with the way the rating agencies assess the structural risks of the deals (i.e. legal risks, cash flow analysis, third parties' involvement in the transaction)?

Broadly, yes. We have also noticed that CRAs are being more active in producing reports, market analysis and updates on legal, regulatory, and taxation changes underpinning their analysis. The assessment of third parties' involvement in the transactions is fundamental as the role of SPVs, servicers and trustees is key in the structure of the transactions. Some of our investor members have noticed that there are sometimes perceived inconsistencies between certain asset classes in the relative importance of certain key risk factors. For example, in many, if not most structures, SPVs are utilised to enhance ring-fencing, while in others there are no SPVs used. Also, the strength of legal opinions is sometimes different between asset classes. Investors recommend that pre-sale ratings reports include descriptions of how the CRAs reconcile these differences and how they are reflected in the rating.

5. Are you satisfied with the way the CRAs disclose their methodologies?

Broadly, yes. Significant improvements have been noticed and it is important that CRAs continue to publish the critical rating elements underpinning rating decisions for the various asset classes. We would welcome greater disclosure of information such as the base case probability of default or expected losses (depending on the CRA) of the underlying assets of a deal (and other key figures), when permitted under data protection laws to provide investors and other market participants more insight on the transactions. CRAs should also always be available at short notice to discuss changes with investors and market participants. These changes include the quantification of assumptions or pool performance that would later cause a downgrade or upgrade. This would assist investors in managing their expectations and quantification of what set of factors could potentially lead to a ratings change. On certain products such as CDOs, certain CRAs already provide a service that indicates how close a tranche is to a change in rating. Our investor members recommend that all CRAs disclose the rating methodologies for different asset classes for a given category of rating.

On-going surveillance of the transactions

6. Are you satisfied with the frequency and quality of the information provided by the rating agencies to the market in connection with the monitoring of rated structured products (e.g. monitoring reports, special comments, etc.)? Are you satisfied with the frequency and quality of the information provided by the issuers/arrangers of structured transactions in order to monitor rated structured products?

We have noted generally an increase in the frequency of CRAs public communications although the quality and frequency of the updates varies depending on asset classes and jurisdictions. It would be helpful if the CRAs would announce the frequency of the disclosure of their communications, at a minimum annually. In addition, since at present some CRAs only provide rating confirmations or actions with no explanations, investors recommend that on all surveillance reports, all CRAs disclose rationale and provide commentary for the rating actions on a consistent basis. The ESF is working with the industry to ensure that timeliness, frequency, quality, accessibility and uniformity of information for rated structured products continue to improve.

7. Are you satisfied with the CRAs disclosures on the reasons for a change in a structured finance rating?

Broadly, yes. It is important that such changes continue to be disclosed at the same time as the information was received by the CRAs and that they are uniformly applied. It would be helpful to reduce the time between the announcement and the implementation of the changes assuming the CRAs have sufficient time to analyse the updated information and make any relevant adjustments. It may be helpful if securitisation issuers disclosed pool information to the market at the same time as that information was provided to the CRAs since some of the issuers use this practice. Investors and other market participants such as research teams, valuation providers, traders, risk management teams could make their own assessments at the same time that agencies were doing their own analysis. Significantly more research would be required on this, to assess Data Protection Directive compliance and any existing confidentiality contracts already in place.

Potential risks (conflicts, resourcing)

8. Are there any risks unique to rating structured finance compared to corporate credit rating?

CRAs play an active role in both structured finance and corporate ratings. However, in the case of structured finance ratings, the CRAs' role is often more complex due to the unique risks that each bespoke structure pose and the greater number of parties involved.

Risks of structured finance instruments are not only unique, but vary dramatically among asset classes and jurisdictions. Risks can be transferred on a single asset, on a pool of assets, on a single jurisdiction, on multiple jurisdictions, on a wide variety of assets, including residential and commercial mortgages, loans, credit cards, future flows, leasing contracts, currencies, receivables, commercial paper, default swaps, single-name defaults and portfolio credit risk. Risks can also be transferred on a cash or synthetic base. The risk analysis typically encompasses elements such as legal issues including potentially a legal opinion, credit issues and cash flow analysis. Specific risks of securitised instruments are prepayment risk, interest rate risk, early-amortisation risk, default risk and liquidity risk. There are also many more parties involved in structured finance transactions than in corporate issues, such as servicers, monolines and collateral managers.

For these reasons, structured finance ratings typically require more CRA time and proximity for each deal. In addition, structuring is a process that is not linear, and as such it is relatively easy to, and parties often do, change the structure before the final product. Finally, structured finance ratings differ from corporate ratings because of their more complex aspects and the fact that the rating focuses not so much on the creditworthiness of the issuer but instead on the quality of the underlying assets and on the robustness (in terms of insolvency remoteness of the rated entity) of the transaction structure. It is therefore inevitable that CRAs engage in more frequent discussions as they need to ensure that they fully understand the proposed structures; it is essential to the production of good ratings in this area that the banks' structuring desks and legal departments have a full and close dialogue with CRAs.

Regarding structured finance ratings fees, these are generally paid by the SPV issuer, which in certain cases could be reimbursed by a seller/originator or by an arranger. In theory, as with all other ratings products where fees are paid by issuers, this could create a perception that a conflict of interest could arise. This conflict analysis is no different than with a corporate rating, and CRAs have established policies and procedures to manage such potential conflicts. We also believe that the IOSCO Code of Conduct, which has been implemented by the agencies covering a large proportion of the structured finance rating industry, adequately addresses this concern. In addition, the commercial mitigant to conflicts in both the structured finance as well as corporate area is the potential reputational risk to the CRAs if ratings integrity is compromised.

Regarding the resourcing risk identified in CESR's question, please see our response to Question 13.

9. Are you aware of any CRAs which provide ex post ancillary/advisory services? If so, do you perceive any potential conflicts of interest between the *structured rating activity and any ex post ancillary/advisory services those CRAs may provide (i.e. pricing or valuation models)?*

Certain CRAs provide ex post ancillary services and advisory services. In certain cases research is provided as part of the rating process during a transaction while at other CRAs there is a fee for other services. These ancillary services generally represent a fraction of the revenue generated by the ratings/analytical business. As in the corporate world, and partly as a result of the IOSCO Code requirement, all major CRAs have gone to great lengths to ensure that adequate separations and firewalls exist between structured finance credit analysts and commercial staff. The separation also goes to more senior management level than used to be the case.

10. Is there a risk of conflicts of interest when a rating agency provides the rating of the provider of credit enhancement to structured finance products it has also rated?

We do not perceive any additional risk of a conflict of interest arising that cannot be and is not already adequately managed, in the situation where the CRAs are also the rating provider of the entity providing credit enhancement, such as a monoline. There are various structured finance products where CRAs have multiple roles within transactions. There could be situations where a rating action on a part of the transaction such as structured finance assets is supported by highly rated entities providing derivative products. If structured finance assets are downgraded, the likelihood of the highly rated entity issuing more securities will decrease with a potential rating fee loss. We believe that the CRAs' existing conflict management policies and the potential damage to their reputation from any potential mismanagement of these conflicts mitigates most of this risk.

11. Are you satisfied with the way the agencies' communicate the measures they have adopted to manage those potential conflicts of interests?

Yes. All of the major CRAs covering a large proportion of the structured finance business have conflict management policies available on their website that either follow the IOSCO Code of Conduct recommendations, or highlight and explain where there are deviations.

12. Do you think those measures are effective?

Broadly, yes, and the IOSCO Code of Conduct has increased their effectiveness.

13. Is there sufficient resource and experience at the rating agencies to deal effectively with the demand for structured finance ratings?

The structured finance market in Europe has experienced in the last years a double digit growth fuelled by new entrants, new jurisdictions, new asset classes and innovative structures. Appropriately resourcing this growth is a challenge for anyone involved in this market. A lot of efforts have been made by CRAs to educate not only their staff, but investors as well. While generally CRAs' analysts do not spend their entire working life with the same employer, rating methodologies and other supporting tools are written and therefore can be passed from one analyst to the other. The availability of technically qualified and experienced staff for the most complex products seems to represent an issue not only for CRAs but also for other financial institutions, including issuers, arrangers and investors. It is particularly important that CRAs make qualified staff available during volatile markets to answer investor questions.

IOSCO Code on Structured Finance

14. Does the current IOSCO Code of Conduct for CRAs deal appropriately with the risks in the rating of structured finance?

The question pre-judges that there are additional risks in rating structured products which, as mentioned above, is a view we do not share. We believe, however, that the IOSCO Code of Conduct does deal appropriately with the specifics of structured finance transactions. Fundamentally the rating process is very similar to the more traditional rating process. Overall, the issues at the heart of the IOSCO Code, namely the Quality and Integrity of the Rating Process; CRA Independence and the Avoidance of Conflicts of Interest; and CRA Responsibilities to the Investing Public and Issuers, are equally relevant and applicable to Structured finance ratings. We do not therefore believe that the Code of Conduct needs revising.

Additional comments

15. Are there any additional points you would like to raise, on the basis of your experience in the structured finance business?

We set out below, for your information only, some topics currently under discussion among market participants in the context of structured finance ratings (or ratings generally)

a) Notching Policies. There is an ongoing industry debate around the issue of "down notching". The issue arises when rating a portfolio or fund where some CRAs may issue or threaten to issue a different (often lower) credit rating of a certain asset rated by another CRA, withdraw the existing rating or refuse to rate securities or money market instruments issued by an asset pool or part of a structured product instrument, unless a portion of the assets within such pool or part of such transaction is also rated by the same CRAs. On the one hand, this practice can result in forcing issuers/arrangers to obtain and pay for additional ratings, which increases fee revenues. On the other hand, if a CRA were compelled to use the existing ratings of other CRAs into its own analysis, even if that opinion differs from its own, that CRA would potentially be prohibited from expressing its true opinion.

b) Competition Issues. ESF investors have noted that the encouragement of greater competition through additional CRAs beyond some reasonable number is not necessarily beneficial. If more than for example 4-5 agencies were active, this is would increase the amount of time spent by investors on monitoring the performance, such as whether CRAs are sacrificing conservative criteria in order to bid for more business. Investors are more concerned that CRAs invest in more staff to expand pre-sale report disclosure and methodology, and to expand the frequency and completeness of surveillance reports.

c) Non-Disclosed Ratings. Certain investors have asked that CRAs disclose the transactions on which they have fully completed the rating process, but for which the rating has been withdrawn at the request of the issuer or arranger since it may be lower than other CRAs. This applies to all ratings, not just structured finance products. Although this would provide additional disclosure, there is a risk that this practice could motivate arrangers to request ratings from less CRAs to reduce possible negative publicity. At the moment, investors of course can choose to not purchase investments if their chosen CRA does not rate a particular tranche., or to widen the spread at which they would purchase, assuming that the lack of rating from a particular CRA could indicate a lower rating. In many cases, issuers and arrangers choose to not have all tranches rated by all CRAs because of the significant extra cost and time involved.

d) Standardised Reporting. We would recommend that structured finance issuers use more standardised reporting for pool performance to facilitate the valuation process for investors and other market participants. The ESF has published the Securitisation Market Practice Guidelines to spearhead the efforts to improve and standardise reporting practices and definitions across Europe for RMBS in 2006, and is expecting to publish similar guidelines for CDO transactions later in 2007. Standardised reporting practices and definitions could expedite the transmission of information from servicers to CRAs for surveillance purposes; it could also reduce errors if information is transferred manually; and increase comparability within and among asset classes.

The ESF would welcome the opportunity to present its views on the rating of structured finance instruments to CESR during an in-person meeting with market participants. If you have any questions concerning these responses, or would like to discuss these responses further, please feel free to contact Rick Watson at +44.20.77 43 93 33 (telephone) or rwatson@europeansecuritisation.com (e-mail), or Marco Angheben at +44.20.77 43 93 35 (telephone) or mangheben@europeansecuritisation.com (e-mail).

Yours sincerely,

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