Moody's Investors Service

30 September 2005

Response of Moody's Investors Service to The Committee of European Banking Supervisors' Consultation Paper on the Recognition of External Credit Assessment Institutions

Moody's Investors Service ("**Moody's**") appreciates the opportunity to comment on the guidelines (the "**Guidelines**") proposed by the Committee of European Banking Supervisors ("**CEBS**") in its consultation paper dated 29 June 2005 on the recognition of External Credit Assessment Institutions ("**ECAI**") under the Capital Requirements Directive[1] ("**CRD**"). Moody's appreciates CEBS' consultative process to achieve convergence among supervisors on matters related to the recognition of ECAIs within the European Union ("**EU**"). We endorse CEBS' objective "to provide the basis for consistent decision-making across jurisdictions, enhance the single market level playing field and reduce administrative burdens for all participants, including potentially eligible ECAIs, institutions and supervisory authorities."

Moody's supports the overall approach to ECAI recognition that CEBS has proposed in the Guidelines: (i) a common set of recognition criteria and processes to be applied by competent authorities across the EU, including a common basis application pack; (ii) provisions for a joint assessment process and indirect recognition where ECAIs seek recognition in more than one jurisdiction; (iii) a common approach to mapping ECAI credit assessments to the credit quality steps in the CRD; and (iv) transparent disclosures by supervisors of their recognition process. We believe that this approach will create a consistent and efficient framework for supervisory assessments of an ECAI's eligibility for use under the CRD.

The Guidelines provide that the supervisory assessments address "the objectivity, independence, on-going review and transparency of an ECAI's methodologies and the credibility and transparency of their credit assessments". Moody's recognizes that in doing so, authorities must assess both the quality of an ECAI's ratings and the integrity of its rating processes, since a given rating system can be demonstrated to perform well in the aggregate but ratings may nonetheless be compromised on an individual basis.

In assessing aggregate ratings quality, Moody's believes that authorities should seek to evaluate an ECAIs' stated ratings performance objectives against its performance data as "quantitative evidence of the consistency and predictive power of an ECAI's credit assessments (the outputs of their methodological processes)", rather than

[1] Recast European Parliament and Council Directives 2000/12/EC and 93/6/EEC.

evaluating the specific methodologies and procedures for developing the content of rating opinions. For purposes of assessing aggregate ratings quality, supervisory focus on a given set of analytical or procedural approaches could inadvertently encourage ECAIs to harmonise their individual rating methodologies and processes, and thereby their rating opinions, in order to secure and maintain regulatory approval. Even if preferred methodologies and processes are initially aligned with market practices, the inflexibility of such a system may make ECAIs less capable of responding to innovations and improving their credit analysis in response to evolving markets. Over time, this would undermine the quality of rating opinions to the detriment of the market and the regulatory users of those opinions. In areas related to integrity, however, Moody's understands that authorities have an interest in assessing the processes and procedures that an ECAI has in place to promote integrity.

We are concerned that some of the proposed information to be provided by ECAIs may be overly focused on processes and procedures for developing the content of rating opinions (which can more appropriately be measured with performance data) rather than on those processes and procedures that ensure integrity. In gathering information to evaluate recognition of an ECAI, via the common basis application pack or otherwise, we suggest that supervisors seek to:

a) evaluate an ECAIs' ratings performance objectives and performance data to assess the quality of its ratings in the aggregate, as well as the suitability of use for regulatory purposes;[2]

b) evaluate an ECAI's processes and procedures that are designed to ensure the integrity of its rating process; and

c) require transparent disclosure of an ECAI's rating policies, processes, methodologies and performance to allow ongoing evaluation by supervisors (and the market) of the suitability of the ECAI's ratings for the intended use.

These suggestions reflect the transparency mechanisms that are set forth in the Code of Conduct Fundamentals for Credit Rating Agencies (the **"IOSCO Code"**) published by the International Organization of Securities Commissions in December 2004, which contains robust standards for rating agency behaviour and disclosure.

The remainder of this submission contains our responses to the six questions posed by CEBS in its consultation paper. Should you wish to discuss this submission with Moody's or require any additional information, please do not hesitate to contact us.

Yours sincerely,

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2 Where a rating agency does not have a sufficient performance track record, then the stated performance objectives, and the rating agency's commitment to publicly disclose its performance track record when measurable, could substitute.

Moody's Responses to Questions Posed by CEBS

The Recognition Process

Question 1: If you are an institution or an ECAI, how do you envisage using the proposed recognition process, in particular in cases where applications for the same ECAI are submitted in more than one Member State at the same time?

Moody's is a global credit rating and research firm covering a broad range of debt totalling over US$35 trillion outstanding. Our global ratings coverage includes nearly 170,000 corporate, government and structured finance securities, over 100,000 U.S. public finance obligations, 10,000 corporate relationships and 100 sovereign nations. Moody's has more than 2,000 employees worldwide including more than 1,000 analysts. We have 19 offices around the world, including in a number of major European financial centres. Our analytical teams, while situated to serve local customers and account for important national considerations, are organised along global sectors (such as the derivatives team and the banking team). Moody's utilizes globally consistent rating symbols and definitions, and we implement policies and procedures to promote broad consistency in our overall rating methodologies and practices, and to promote comparability in our ratings globally.[3]

In addition, a growing number of European banks operate in multiple jurisdictions, with affiliates or subsidiaries dispersed throughout Europe. European banks are increasingly taking on exposure to cross-border credits in various market segments, and it is not uncommon for a bank in one EU country to have loans outstanding to borrowers based in other countries, either within or outside the EU. Therefore, it is likely that our ratings will be utilised by banks in most if not all European member states.

Given these considerations, Moody's would anticipate applying for recognition in each of the three main market segments delineated by CEBS (public finance, commercial entities and structured finance) in all 25 member states. We would seek recognition at the group level (that is, for all Moody's operations that are under the common control of Moody's Corporation, the parent company) rather than for individual subsidiaries. Moody's therefore strongly supports CEBS in seeking a common process for recognition in multiple jurisdictions.

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[3] Moody's global corporate, structured finance, and non-US public finance ratings use the same symbol system and are intended to convey comparable information with respect to the relative risk of expected credit loss. Moody's ratings on public finance securities issued in the US tax-exempt market use the same symbol system but correspond to a different set of expectations of relative expected loss and thus are not intended to be compared directly to our other ratings. See "Moody's US Municipal Bond Rating Scale," *Moody's Special Comment*, November 2002.

Question 2: Do you support the proposed joint assessment process? Does it address the need for efficiency, consistency, and reduced administrative burdens in light of the CRD requirement that each competent authority make its own decision (direct or indirect) on eligibility?

As noted above, Moody's strongly endorses the joint assessment process for recognition of ECAIs ("**Joint Assessment**"). We agree with CEBS that implementation of the Joint Assessment should "avoid duplication of work, promote supervisory efficiency, and reduce the overall burden of the recognition process". We appreciate CEBS' efforts to encourage recognition of ECAIs through a common process without further national reviews. However, we recognize that in carrying out their responsibilities under the CRD to make recognition decisions, some national authorities may determine that further review is necessary.

In that regard, we welcome the suggestion of a process facilitator to coordinate and ultimately produce the Joint Assessment. We believe that these activities will smooth the operation of the Joint Assessment, encourage national reliance on the joint assessment process, and support CEBS' broad objectives for consistency and efficiency. It may also be helpful to participants if additional guidance were provided on the means by which the process facilitator is to be selected. Consistent with the CEBS guidance for the Joint Assessment process, factors related to the particular circumstances of the ECAI, such as the primary location of its business in Europe, the jurisdiction in which it has the greatest ratings coverage or the jurisdiction having the greatest concentration of banks that may seek to use the ECAI's credit assessment, could be applied in selecting the process facilitator. In addition, further guidance on the role of the process facilitator to encourage, for example, coordination of additional national information requests or communication among process facilitators, may also further ensure an efficient and consistent process.

The Recognition Criteria

Question 3: What are your views on the proposed common understanding of the CRD recognition criteria to be implemented by supervisors in determining the eligibility of ECAIs?

Moody's welcomes the efficiencies that CEBS's common understanding of the CRD recognition criteria seeks to create. As noted in the Guidelines, "the key purpose of the recognition criteria is to identify ECAIs that produce external credit assessments of sufficiently high quality, consistency and robustness to be used by institutions for regulatory capital purposes…" The Guidelines recognize that reviewing ECAI's public disclosures in areas such as "adherence to a code of conduct in line with market standards and internationally recognised principles" and a demonstrated "track record of producing robust credit assessments (outputs)" should be indications that a given ECAI conforms to relevant CRD criteria.

These principles are consistent with Moody's views expressed earlier in this document, whereby we believe that (i) assessments of ratings quality in the aggregate should focus on the ECAI's outputs rather than on the appropriateness of the specific methodologies or processes used to develop the content of the ratings, and (ii) assessment of ratings integrity may necessarily involve reviews of specific processes and procedures designed to ensure integrity. These reviews, combined with transparent disclosure by ECAIs of rating methodologies, procedures and performance pursuant to the IOSCO Code, should provide competent authorities with sufficient information to make eligibility assessments while avoiding the unintended consequence of encouraging or requiring harmonization in ECAI analytical and rating methodologies and ultimately their rating opinions.

Following are examples of proposed "minimum information to be provided to the competent authorities" via the Common Application that we believe could encourage such unintended and unfavourable harmonization.

- *"For each of the asset groupings within which a core methodology is applied consistently… a high-level description of quantitative inputs: key variables, data sources, assumptions and quantitative techniques used, extent of input from rated entities, etc."*
- *"For each of the asset groupings…a high-level description of qualitative inputs in particular the scope of qualitative judgement e.g. regarding the strategy, business plans of the rated entities, etc."*
- *"Demonstration and certification that members of the rating teams and committees have appropriate and requisite skills – including quantitative expertise – and experience in credit assessment, and that these skills are maintained or improved over time through adequate training programs."*
- *"General information on rating reviews: e.g. the process in place, main characteristics, scope, frequency, people/teams involved, means used, treatment, main phases of the monitoring process, data updates, information from rated entities taken into account, automatic warning systems, mechanisms that allow systematic errors in credit assessments to feedback into potential changes in ratings method, etc."*

In finalizing its guidelines on required information to support the CRD recognition criteria, we encourage CEBS to clarify that such information should be used only for purposes of assessing the *integrity* of an ECAI's processes for eligibility under the CRD, and not in lieu of actual *performance quality* for determining performance suitability of an ECAI's ratings. If the above information is used for the latter purpose, it may unintentionally influence and force conformity upon the independent methodologies and content of ECAIs' rating opinions.

Mapping

Question 4: What are your views on the proposed approach for implementing the mapping process?

Moody's agrees with the general principles established by CEBS in relation to mapping:

- In order to make self-reported default and loss rates comparable (across industry sectors and among ECAIs), competent authorities will likely need to make adjustments for differences in definitions of default, measures of loss, calculation methods for default and loss rates, and sector coverage.

- The competent authorities should in no way seek to influence or change the assessment models, processes and methodologies employed by the ECAI.
- Absolute accuracy in the mapping process is neither necessary nor likely to be possible.

Question 5: Do you support the proposal that the "mapping" of credit assessments to risk weights should also be addressed under the Joint Assessment set out in Part 1 for applications made in more than one member state?

Moody's would strongly support addressing the mapping of credit assessments under the Joint Assessment to promote a consistent and efficient process. We believe that disparities in mapping outcomes across jurisdictions could result in inconsistent treatment of comparable credit risks by banks, where for example banks may be required to hold different amounts of capital for the same credit risk depending on the jurisdiction. Such inconsistency may create inefficiencies for multi-jurisdictional banking institutions and expose the European regulatory system to regulatory arbitrage.

Question 6: Do you think that the concept of loss, rather than default probability alone, is the appropriate key parameter for mapping securitisation credit assessments? If not, what should be the appropriate parameter? How should it be measured statistically? To what extent do the same considerations apply for CIU credit assessments?

1) General Considerations for Mapping Securitization Credit Assessments

Regarding securitization mappings generally, we believe it would be appropriate to have a single mapping for an ECAI's structured finance ratings across all the sectors for which its ratings are recognized, rather than developing different mappings for different sectors. Moody's structured finance ratings are intended to imply the same expected loss rates for a given rating category in all asset classes and across all geographies.

Historical loss rates have, however, varied across asset classes and regions, as well as over time, within the structured finance segment, as they have also varied within the corporate sector (e.g. due to asynchronous credit cycles).[4] Differences in historical loss rates, however, may not be indicative of expected future differences in credit risk. On the contrary, history shows that weaker performing sectors sometimes become stronger performing sectors in later years and vice versa.[5] If Moody's were to conclude, based on historical evidence, that *expected* future loss rates per rating category were systematically different in one sector than in other sectors, we would likely adjust our ratings methodology in that sector to bring its expected loss rates back in line with those of other sectors.

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[4] Sectoral breakdowns of loss rates within structured finance by rating category are presented in "Default & Loss Rates of Structured Finance Securities: 1993-2004," *Moody's Special Comment*, July 2005.

[5] For example, commercial mortgage backed securities underperformed other securities in the early 1990s and subsequently outperformed other sectors over the next decade.

When developing mapping for structured finance ratings, we believe careful consideration should also be given to the degree of linkage between the meaning of corporate and structured finance ratings. Moody's bases its structured finance ratings on idealized expected loss targets derived from historical experience in the corporate segment. For example, in our ratings of collateralized debt obligations, collective investment undertakings ("CIUs"), financial guarantors, and structured investment vehicles, Moody's measures the asset quality of these investment vehicles and companies equivalently, based on the ratings of their underlying invested assets or asset guarantees, regardless of whether the invested or guaranteed assets are structured or corporate obligations. If Moody's believed the expected future loss rates associated with structured finance ratings were systematically different from those of our corporate ratings, we would likely adjust our structured finance rating methodologies to bring the expected loss rates of the two segments back into line.[6]

2) Parameters for Mapping Securitization Credit Assessments

Moody's believes that the concept of expected loss is more appropriate than default probability for mapping securitisation credit assessments. We believe that expected loss rates are more closely aligned to real economic risk than default probabilities. For example, based on our experience, roughly 20% of all missed interest payments on structured finance securities are ultimately cured in full. Moreover, many uncured defaults on highly rated securities are associated with relatively low loss severity. Therefore, simple default rate measures can overstate the true economic risks of highly rated structured securities. Furthermore, a capital charge system that is based on default probability-based ratings can be arbitraged through tranching a given exposure into junior and senior pieces, resulting in a lower weighted average capital charge.

As noted in the Guidelines, in order to make self-reported default and loss rate statistics comparable (across industry sectors and among ECAIs), adjustments may be necessary for differences in default and loss study methodologies and sector coverage. In particular, we suggest that competent authorities remain mindful of the differences among ECAIs in their definitions of default and methods of loss rate calculation.[7]

3) Considerations for CIU Credit Assessments

Moody's assigns credit ratings to two types of CIUs – bond funds backed by actively managed long-term bond portfolios (bond funds) and constant net asset value money market funds (money funds) that are also supported by actively managed fixed income portfolios. A bond fund's credit rating reflects the weighted average expected credit loss rate on its current portfolio investments and, because of the fund's

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[6] It should also be noted that, given the ease with which structured finance technology can transfer corporate risk into structured risk, any capital charge framework that treats ratings in the corporate segment differently from those in the structured finance segment (or any sector within structured finance) would create incentives for arbitrage.

[7] Moody's structured finance default definition includes all missed interest or principal payments (including situations in which missed interest payments are capitalized through an increase in payment-in-kind obligations), all security balance write downs, and (in our material impairment definition) all downgrades to Ca or below to capture situations in which substantial security losses are certain by not yet realized. Our method of calculating default and loss rates includes an adjustment for the censoring that occurs when securities are retired and ratings are withdrawn. This adjustment can increase measured default and loss rates substantially.

commitment to manage its portfolio pursuant to specific investment guidelines, on its expected future portfolio investments. The money fund's credit rating reflects the likelihood that it will maintain a constant net asset value.[8] In both cases, Moody's CIU credit ratings correspond closely to the rating we would assign to the underlying pool of securities – be they corporate or structured finance obligations – if they were collectively held on an investor's balance sheet.

[8] Note that unlike a traditional fixed income investment, neither bond funds nor money funds are subject to a final maturity. Also, bond funds make no representation about principal repayment. Accordingly, there is always market risk associated with fixed income funds that may be relevant for capital allocation. The market risk for bond funds depends largely on the duration of those funds. Moody's expresses a view on this risk through its assignment of Market Risk ratings as companions to our fund credit ratings.