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Committee of European Banking Supervisors ("CEBS")

Dear CEBS Members:

Subject: DBRS's Response to the CEBS Consultation Paper on the Recognition of External Credit Assessment Institutions

Dominion Bond Rating Service ("DBRS" or the "Company") is pleased to submit this response to the CEBS proposed common approach to the recognition of eligible External Credit Assessment Institutions ("ECAIs") for purposes of Basel II. DBRS understands that the purpose of ECAI recognition is to provide a basis for capital requirement calculations, for institutions that use the Standardized and the Securitization Ratings Based Approaches.

An important first aspect of this process is the assessment of the eligibility of credit rating agencies by CEBS member state supervisory authorities based on the Capital Requirements Directive ("CRD") recognition criteria, and information contained in the "common basis application pack". DBRS appreciates the transparent process the CEBS has undertaken to achieve a common understanding and convergence among the various supervisory authorities on the recognition criteria, application, and assessment process to date. It is no small feat to achieve a single market and level playing field for all credit rating agencies. DBRS endorses the proposed broad set of recognition criteria and encourage the CEBS to ensure that its recognition criteria are similar to those used by Canadian and U.S. regulatory authorities.

DBRS desires the unfettered ability to compete in all market segments – commercial entities, public finance, and structured finance – in every European jurisdiction and looks forward to working with supervisory authorities in the member states. DBRS has a proven track record, a strong infrastructure, and an appropriate framework of policies and procedures to meet the proposed ECAI requirements. For background, below is a brief overview of DBRS followed by DBRS's responses to the six questions specifically asked of respondents, integrated with DBRS's comments on several provisions contained in the proposal document itself.

Overview of DBRS

Based in Toronto, with offices in New York, Chicago, London, and Frankfurt, DBRS was founded in 1976 by Walter Schroeder, who remains the company's president. DBRS is privately owned, is not affiliated with any other organization, and limits its business to providing credit ratings and related research. DBRS is a "generalist" rating agency, in that DBRS analyzes and rates a wide variety of financial institutions, corporate structures, government bodies, and various structured finance transactions. DBRS rates over 1,000 entities worldwide, has 150 employees, and has plans to expand, especially in the U.S. and Europe. Staffed with local expertise and timely decision-making ability, each of DBRS's locations adheres to companywide practices and procedures to ensure consistent application of DBRS's core credit methodology, and comparability of credit assessments undertaken in different countries/jurisdictions.

DBRS is globally recognized as a provider of timely, in-depth, and impartial credit analysis. The company's opinions are conveyed to the marketplace using a familiar, easy-to-use letter grade rating scale. These ratings, along with comprehensive rationales to support each rating opinion and action, are publicly available on DBRS's website (www.dbrs.com) and through the Bloomberg and Reuters networks. DBRS also makes full rating reports, industry studies, commentaries, and securitization servicer reports available to paying subscribers. DBRS has more than 4,500 subscribers, including institutional investors, financial institutions, and government bodies. Investor support of DBRS continues to grow, with international investors accessing DBRS's ratings more than 64,000 times a month via the DBRS website.

From inception, DBRS has refined its expertise in the analysis of credit quality, maintained professional standards, and met external regulatory requirements.

Investors and borrowers alike have come to rely on DBRS's ratings as the standard in the Canadian marketplace. DBRS has been recognized by the Ontario Securities Commission as an "approved rating organization". In February 2003, DBRS was designated as a Nationally Recognized Statistical Rating Organization ("NRSRO") by the U.S. Securities and Exchange Commission's Division of Market Regulation ("SEC"). In order to receive its NRSRO designation, DBRS demonstrated that it is widely accepted in the U.S. as an issuer of credible and reliable ratings by users of securities ratings. DBRS also established that it has adequate qualified staffing, financial resources, and organizational structure to ensure that it can issue credible and reliable ratings of the debt of issuers, and the ability to operate independently of economic pressures or control by the companies it rates. In addition, DBRS demonstrated that it uses systematic rating procedures designed to ensure credible and accurate ratings; and that it has and enforces internal procedures to prevent conflicts of interest and the misuse of non-public information.

In October 2003, DBRS was formally recognized by the National Association of Insurance Commissioners ("NAIC"), which means that DBRS ratings can be used when converting credit ratings to NAIC numbers. Approximately 8,000 insurance companies in the U.S. use DBRS ratings to assess capital requirements.

DBRS works with a wide range of regulatory and industry groups to develop uniform standards to ensure that rating agencies disseminate credit ratings that are independent, objective, and credible. For example, DBRS contributed to the development of the International Organization of Securities Commissions' Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code"), and has agreed to abide by the IOSCO Code. More recently, NRSROs and SEC staff have been engaged in negotiations to craft an oversight framework that would further address the rating agencies' continued compliance with the NRSRO designation criteria while also incorporating the IOSCO Code.

DBRS has undertaken a preliminary self-assessment against the proposed six conditions for recognition as an ECAI under Basel II at the request of the Office of the Superintendent of Financial Institutions ("OSFI"), Canada's federal banking regulator. OSFI's six conditions are very similar to the criteria and methodology outlined in the proposed common application pack, noting of course that the requirements for Basel II are international.

DBRS's responses to the six specific questions:

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?**

DBRS plans to apply to all member states as an ECAI in each of the market segments – commercial entities, public finance, and structured finance, and submit a prioritized list of the member states for which DBRS will seek recognition. DBRS plans to apply based on the criteria contained in the common application pack. DBRS's approach will facilitate a coordinated joint assessment process while responding to country-specific requirements above those set out in the common application pack.

DBRS plans to begin informal application in the interim period until the recognition guidelines and assessment procedures are finalized to ensure DBRS establishes appropriate communication and expectation levels with the various supervisory authorities.

DBRS wishes to note that it has a strong concern with paragraphs 13 and 21 in the proposal document that require an ECAI to "demonstrate that at least one institution in the competent authority's jurisdiction intends to use its credit assessments for prudential risk-weighting purposes". DBRS submits that these clauses create a de facto competitive barrier in the European rating industry that DBRS believes CEBS may not have intended. DBRS suggests that where a European banking institution would do that, they would likely only deal with already well-established credit rating agencies in their jurisdictions; however, these credit rating agencies would not yet have been determined to meet the proposed ECAI recognition criteria. DBRS also suggests that a banking institution may hesitate to use a particular rating agency until it has been widely recognized as an ECAI, which is the likely scenario for smaller rating agencies such as DBRS. This is a paradoxical challenge that DBRS believes the CEBS either did not contemplate or intend.

Instead, DBRS suggests that the CEBS focus on determining whether a firm can credibly rate companies in the markets in which it operates or wishes to operate through a review of a firm's organization and infrastructure, the adequacy of its policies and procedures, the thoroughness and objectivity of its ratings process, a sufficient performance history, and other ECAI criteria as proposed. That is, the prime and only requirement should be the recognition as an ECAI, based on transparent eligibility criteria so that the European markets can then use any accredited ECAI they wish. Otherwise, the proposed approach is punitive against those firms that have a strong history and reputation for objective and credible ratings but are perhaps less well known in the member states.

Moreover, DBRS believes the marketplace is the best judge of what constitutes a reliable credit rating. Gaining acceptance in the U.S. market, for example, is a relatively more straightforward, albeit lengthy, process than doing so in the European market, given the critical mass of banking institutions, mutual funds, pension funds, broker-dealers, and insurance companies – apart from other avenues of "proof of acceptance" in the U.S. such as citations in the financial and mainstream media. The European market is, by its very nature, a smaller and more diverse mosaic.

Where a time frame for market acceptance is considered necessary, DBRS suggests that ECAIs be given a reasonable period such as three to four years in which to demonstrate that an institution plans to use an ECAI's credit assessments for risk weightings.

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?**

DBRS strongly supports the proposed joint assessment process where supervisory authorities recognize an ECAI based on recognition in another member state without having to carry on its own assessment. This approach will avoid unnecessary duplication of effort and reduce the compliance burden for rating agencies such as DBRS, who intend to apply in a number of member states. While respecting the need for individual decision-making and possible additional requirements by particular countries, DBRS very much encourages the supervisory authorities in the member states to mutually agree to key eligibility criteria and a coordinated joint assessment process. DBRS also suggest that, apart from particular regulatory issues in each country, the areas of review be the same types of requirements that countries such as Canada and the U.S. have also adopted or plan to use.

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?**

DBRS suggests that the areas and questions as set out in the common application pack appropriately capture the critical ECAI eligibility criteria and should suffice as the basis of the joint assessment approach and decisions made (direct or indirect) by all member states. As outlined in the Overview of DBRS, these criteria are very similar to those required by OSFI, and underline the NRSRO recognition criteria required by the SEC and those required by the IOSCO Code. In any case, the minimum eligibility criteria should focus on ensuring that each ECAI has an appropriate infrastructure and governance framework (including rigorous policies and procedures) to ensure the transparency and objectivity of the rating process, prevent conflicts of interest and misuse of non-public information, and to make timely public disclosures.

In addition, the criteria should require a sufficient performance history to prove ratings accuracy and broad market acceptance but with a reasonable time frame for newer industry participants to meet these criteria.

DBRS agrees that the assessment process should focus on the proposed technical criteria outlined under the Methodology section. In particular, note the following:

- The assessment of objectivity based on the three factors per paragraph 83 appropriately focuses on review of systematic methodologies that incorporate quantitative and qualitative factors/measures, the rigorous application of these core methodologies, a transparent and objective rating process, and a statistical rating performance history.

- DBRS published a Corporate Default Study in April 2005 for its corporate/commercial sector, which focuses on historical default performance in the DBRS-rated universe from the time of DBRS's inception (1976) to 2004. To date, DBRS has experienced no defaults on its structured finance ratings and so, has not yet conducted a study; however, a default study for this and other segments (as well as a study on ratings transitions) will be published in the future. The Corporate Default Study can be found on the DBRS website (www.dbrs.com).

- DBRS agrees that assessment of independence should focus both on the economic and political pressures and influences that may compromise a credit rating agency; however, DBRS does wish to note that though DBRS is a private company, DBRS maintains the highest professional standards and, moreover, must continue to meet and comply with external regulatory requirements that prevent DBRS from using its position to secure particular business or produce favourable credit assessments. In addition, no single issuer accounts for more than 1% of DBRS's total revenues. DBRS agrees that the onus should be on the ECAI to demonstrate that it has adopted appropriate internal policies and procedures.

- With respect to the back-testing requirement per paragraph 97, DBRS has conducted back-testing for commercial entities and will draw upon its Corporate Default Study to satisfy the valuation criteria based on historical experience.

- The term "material change in methodology used for assigning credit assessments" per paragraph 99 needs to be more specifically defined in the proposal document to ensure that all ECAIs submit changes on the same basis and that there is no disparate treatment about these changes among ECAIs.

- DBRS agrees that credibility and market acceptance are integral to the recognition of an ECAI (and that these factors were among the critical determinants of DBRS's obtaining the NRSRO designation in 2003); however, DBRS submits that the European market is quite different from the U.S., and that for DBRS to demonstrate strong market acceptance in member states would be somewhat more difficult, as discussed in DBRS's response to Question 1. DBRS suggests that for credit rating agencies that are relatively less well known in Europe or in a particular member state, supervisory authorities should be encouraged to undertake a greater level of assessment. As outlined in paragraph 110, other indicators of market credibility should be permitted e.g. many institutions plan to use an ECAI's credit assessment; however, DBRS requests that the term "large number of institutions" be clearly defined. Other indications of market acceptance should also be included, such as planned ECAI usage by broker-dealers, and the number and type of citations of the ECAI in well-known industry journals or newspapers (international and/or local). Moreover, DBRS suggests that a reasonable time frame such as three to four years be permitted to establish broad market acceptance in the international European community.

- DBRS agrees that an ECAI's credit ratings should be made publicly available to domestic and non-domestic parties on equivalent terms, and that there is a need to distinguish between situations where the ECAI charges versus does not charge subscribers. Indeed, public dissemination of DBRS ratings is the very basis of DBRS's business model and, therefore, all ratings, ratings methodologies, and indices are available on www.dbrs.com to the public at no charge. DBRS *does* charge subscribers for full ratings reports, real time e-mail alerts, and industry studies, which allows DBRS to disseminate high-quality ratings to the public at no cost. In order to ensure that this practice does not harm financial markets, DBRS has adopted an effective range of controls to prevent the selective disclosure of ratings, rating actions, and other non-public information to its subscribers. DBRS's credibility and market acceptance are its most valuable assets. Suspicious or inaccurate ratings would undermine DBRS's credibility. If DBRS were seen to appease any issuer by supplying an inflated rating, the marketplace would discount the credit opinion. DBRS could not avoid the reputational impact of any conflict of interest by concealing the reasons for its ratings, since ratings have to be transparent in order to be deemed valuable by market participants.

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

DBRS appreciates that the mapping process will consider qualitative factors above the stated specific quantitative requirements to allow for differences in ECAI methodologies and time periods for cumulative default rates ("CDRs"). In particular, DBRS notes that paragraph 123 states that supervisory authorities "will base their assessments on the credit assessment models, processes and methodologies presented by the ECAIs". Paragraph 140 also states that where ECAIs use significantly different approaches, supervisors should consider adjusting their assessment for qualitative factors such as the definition of default, the pool of issuers covered by the ECAI, the statistical significance of the ECAIs' default rates and the meaning of the credit assessment. For example, one of the key quantitative criteria stated in the proposal document per paragraph 132 is a CDR on a three-year basis. For DBRS's Corporate Default Study, DBRS calculated a range of CDRs including a three-year CDR. The study discusses five-year and ten-year CDRs based on DBRS's default experience from 1977 to 2004 using a database of 31,000 ratings events and a total of 27 corporate defaults, which DBRS sees as providing an appropriate basis for DBRS's conclusions.

DBRS's Corporate Default Study also outlines the strict methodology used, including the underlying definition of default. The results demonstrate the effectiveness of DBRS's ratings as a default predictor, both from the perspective of time to default and ultimately probability of default. The cumulative default curves stratified by ranking category, illustrate the rank-order effect of ratings versus default experience over time. DBRS suggests that its Corporate Default Study is a suitable basis for the supervisory authority mapping exercise. DBRS would be pleased to provide additional detail as necessary.

Default statistics and ratings transitions for other debt and structured finance categories will form part of a separate study. It is important to note that there have been no structured finance defaults in the DBRS-rated universe to date.

5) Do you support the proposal that the "mapping" of credit assessments to risk weights should also be addressed under the joint process set out in Part 1 for applications made in more than one Member State?

In order to promote efficiency and cost-effectiveness for both the supervisory authorities and the ECAIs, DBRS supports the proposal that the mapping of credit assessment to risk weights also be addressed under the joint assessment process for applications made in more than one member state. DBRS refers the CEBS to the points regarding the joint assessment process made in DBRS's response to Question 2.

6) Do you think that the concept of loss, rather than default probability alone, is the appropriate key parameter for mapping securitization 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?

DBRS believes that it is generally inappropriate to analyze expected losses in isolation, whether for structured finance/securitization or commercial/corporate credit assessments. DBRS mainly focuses on the likelihood of default. At higher rating levels, where investors do not expect any defaults, DBRS focuses on default. At lower rating levels, DBRS may widen the difference between senior debt and sub-debt to reflect that losses will be much greater for sub-debt. DBRS moves the rating to "D" if there is any default, regardless of whether or not the loss will be large. DBRS generally believes that the most informative measures to consider are the probability of default by rating grade and by time to default.

Most buyers of structured finance/securitization products are generally looking for AAA rated, nearly risk-less investments that are extremely unlikely to default.

Concluding remarks

DBRS looks forward to participating in the assessment process for ECAI recognition in Europe and to working with the supervisory authorities in the member states. DBRS plans to expand across Europe and to compete in every jurisdiction in all market segments. This consultation paper allows DBRS to participate from the start, to ensure that all credit rating agencies receive due ECAI consideration.

DBRS suggests that the recognition/eligibility criteria, the joint assessment approach, and the mapping process are largely appropriate and inclusive; however, DBRS believes that one critical area requires re-examination: the need to prove that at least one institution within the member state's jurisdiction intends to use the ECAI's credit assessment for risk-weighting. This particular requirement prevents credit rating agencies that otherwise meet the ECAI recognition criteria (including alternative means of market acceptance) from establishing relationships with institutions that plan to use the firm's credit assessments under the Standardized and the Securitization Ratings Based Approaches. DBRS understands that the CEBS advocates full competition in the European market. However, this requirement is in fact anti-competitive and very punitive for agencies such as DBRS, which has a proven 30-year track record in other markets such as North America but is perhaps less well known in Europe at this stage. DBRS strongly urges the CEBS to reconsider this requirement.

DBRS would be pleased to make itself available at your convenience to further discuss DBRS's comments and answer any questions you may have. In the interim, please do not hesitate to contact me at +1 416-597-3614.

Thank you for including DBRS in this very important initiative.

Sincerely,

Mary Keogh
Managing Director, Policy

cc:
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