Michael FALLON MP
Graham BRADY MP
Peter VIGGERS MP

Dartmouth.

SUBJECT: Financial transparency and stability/rating agencies

Dear Sirs,

In the context of the recent Commons Treasury Select Committee's hearings I believe you may find an interest in the following.

The ongoing sub-prime crisis has caused the main credit rating agencies to come under some scrutiny, on both sides of the Atlantic.

Well-informed observers have pointed a finger at obvious conflicts of interest within the agencies, stemming mainly from the fact that they are unregulated and paid by the very entities they are supposed to rate; these conflicts cast serious shadows upon not only the conditions in which ratings are attributed but also the validity of these ratings, and the agencies have already attracted severe criticism on this score in the past.

When this happens one of their preferred lines of defence, besides invoking the First Amendment (in the US), is to underline that their ratings can only reflect the information which has been disclosed to them, and that they cannot bear any responsibility for negative items which might have been withheld; in this respect the ENRON debacle, among others, was a case in point.

I believe this argument to be fallacious and I would like to describe two very precise, verifiable and irrefutable instances which will prove my point. I realise both instances will appear to be somewhat removed from the matter of asset or mortgage-backed securities, however I believe they clearly illustrate the pernicious effects of the very same conflict of interest which is at the root of the crisis affecting Northern Rock and many other financial institutions throughout the world, which is why I respectfully bring them to your urgent attention.

These instances are the unjustified "investment grade" ratings attributed to the sovereign issues of both the People's Republic of China (PRC) and the Russian Federation (RF), two governments who have consistently refused to honour the debt of their predecessor internationally recognised governments, prior to 1949 in the case of the PRC and prior to 1917 in the case of the RF, in flagrant violation of the *successor government doctrine* of settled international law.

Both issuers have notoriously defaulted on their obligations, and the notices of both defaults have been officially communicated to the main rating agencies.

All three major agencies publish their rating rules and definitions; in particular they state that their ratings are, among other things, an evaluation of the issuer's *willingness to pay* his financial obligations, a *willingness* all too clearly absent in the case of both the PRC and the RF, who may punctually pay both capital and interest on modern-era PRC and RF bonds listed on the Luxembourg stock exchange, but never do on pre-1949 Chinese or pre-1917 Russian bonds (*).

The agencies have a specific rating for such circumstances - which Standard and Poor's call "SELECTIVE DEFAULT" (SD) - and which quite clearly applies to both the PRC and the RF. Yet both issuers have been attributed "investment grade" ratings by all three major agencies.

So, it is blatantly clear that contrary to their argument it is not through lack of knowledge, but on the contrary despite irrefutable knowledge of selective defaults, and in violation of their own published criteria, that the agencies have attributed both the PRC and the RF with unjustified "investment grade" ratings instead of the deserved "SELECTIVE DEFAULT". As a result, past, present and future investors are being very seriously misled on issues worth billions of dollars, as they are in the case of mortgage-backed securities.

Why is this so?

It is common knowledge that both public and private issuers from the PRC and the RF have issued stocks and bonds in increasingly massive quantities over the past decade in international markets. Obtaining an investment grade rating is, for a new issuer, a prerequisite for any significant placing of bonds in international markets; therefore the prospect of these issues, particularly in bonds, has represented massive potential windfall profits for the agencies, whose revenue can in this respect be a percentage of the capital amount of the issues rated.

It is crucial to understand that it is not the custom for an agency to attribute a better rating to any private issuer of a given country than the rating attributed to that country's government. I believe that therefore, had the agencies attributed to both the PRC and the RF governments the "SELECTIVE DEFAULT" ratings they quite obviously deserve, the agencies would as a consequence have forfeited all the anticipated revenue stream from subsequent private issuers of those countries, since by virtue of the above custom these companies would have been rated at best "SELECTIVE

DEFAULT"; knowing that in such circumstances they had no chance of attracting foreign investors, the issuers would have refrained from requesting a rating, and the agencies would have forfeited a revenue stream in the hundreds of millions of dollars.

In the case of the RF the default bears on a conservative estimate of over US$ 90 billion in capital and interest; in the case of the PRC I believe it to be in the hundreds of billions of US dollars.

I have tried to describe this mechanism as concisely as I could. It is very similar to that which has led to what are in my view unjustified ratings being attributed to the massive amounts of asset and mortgage-backed securities at the root of the present sub-prime crisis.

This mechanism is documented in great detail in two extremely well researched and prepared documents from Sovereign Advisers, a firm of independent financial analysts which I am in contact as a holder of defaulted Russian bonds. They are to be found at the following URLs:

http://www.globalsecuritieswatch.org/Letter_to_the_European_Commission.pdf

http://www.globalsecuritieswatch.org/world-news.pdf

Sovereign Advisers maintains the www.globalsecuritieswatch.org website, where you will find a lot more excellent, verifiable documentation on this matter.

Holders of defaulted PRC and RF bonds strongly advocate for appropriate regulation of the rating agencies in order to put an end to such questionable practices, and so that the PRC and the RF should be appropriately rated "SELECTIVE DEFAULT".

You may be interested to know that some holders of Russian bonds have written to European commissioner McCreevy (who is scrutinising the rating agencies for any possible areas of conflicts of interest and has asked the Committee of European Securities Regulators to include the specific matter of conflicts of interest in its report due in April 2008), and also to all members of the European Parliament's Monetary Affairs Committee, which has launched its own hearings of the rating agencies. You will have known that this summer both president Sarkozy of France and German chancellor Merkel voiced their preoccupation on these matters to the European Commission and G8 Finance ministers.

Independently, a group of holders of defaulted Russian and Chinese bonds are considering lodging an official petition with the European Parliament.

I would be delighted to provide you with any further information on this matter should you so require.

Thank you for your attention.

(*): Please note that ALL pre-1917 Russian government-guaranteed bonds have been continuously listed from the date of issue, and still are today, on the official regulated Paris stock exchange; yet contrary to contractual obligations and present-era Russian bonds, they pay no interest or capital since 1918.

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Rating agencies/Monetary Affairs Committee
Sent: 22 October 2007 18:44:39

To: Graham Watson MEP

Dartmouth, Monday October 22nd 2007.

Dear Sir,

As a citizen living in Dartmouth I may perhaps to some extent be considered as one of your constituents.

For your information I am forwarding to you a copy of a letter several of the 316.000 french holders of defaulted Russian bonds have written to all members and deputy members of your Monetary Affairs Committee on the matter of conflicts of interest within the main rating agencies.

I know the matter of defaulted Russian bonds may seem removed from the sub-prime crisis and its causes, however I believe the document to be self-explanatory.

I would be very glad to comment on it further should you so require. We are considering introducing an official petition to the European Parliament in the future on this matter and I shall take the liberty of making contact with you again nearer the time.

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October 2007.

To the Monetary Affairs committee.

Madam Chairman,
Vice-chairmen and members of the Economic and Monetary Affairs committee,

In the current market turmoil Commissioner McCreevy is examining the activities of the credit rating agencies with a view to assessing their impact on financial markets. He has asked the Committee of European Securities Regulators (CESR) to specifically examine areas of possible conflicts of interest, such as the fact that the agencies are paid by the very institutions they rate. This matter has been raised before, and one of the lines of defence usually taken by the agencies is to remind operators and regulators that the ratings they issue can only reflect the information which has been made available to them. I believe this particular affirmation to be obviously false, as illustrated in the examples outlined below.

I am raising this subject with you because your committee is launching its own examination into the activity of the rating agencies.

As a French holder of several issues of defaulted Russian government bonds presently listed on the official Paris stock exchange list named 'Eurolist by Euronext', I wish to respectfully bring to your attention the rating of the Russian Federation on, which I believe provides a good example of how a conflict of interest can result in the attribution of unjustifiably high quality ratings to defaulted sovereigns, despite the agencies' full knowledge of that default.

In 1918 the Bolshevik government unilaterally defaulted on all Paris-quoted russian bonds and since then the successive internationally recognised governments of Russia have refused all contact with their bona fide creditors, in flagrant violation of accepted principles of international law.

As a holder of such bonds I am shocked to see that the three main credit rating agencies attribute an "investment grade" rating to that issuer; these agencies have been formally notified of Russia's default on these bonds, and by attributing an "investment grade" rating to that issuer these agencies are, in particular, disregarding one of their own self-imposed metrics, which is to address the issuer's willingness to pay on existing issues.

Since Russia is clearly not willing to pay (and has in fact notoriously defaulted) on the above mentioned Paris-listed issues, while it simultaneously pays both interest and capital on the Russian government bonds listed in Luxembourg, that issuer is quite clearly in "selective default", a situation which is not reflected in the present "investment grade" rating. Present and potential investors are being seriously misled.

This situation is identical to that which prevails concerning the People's Republic of China (PRC) who has also issued Luxembourg-quoted bonds and refuses to honour pre-1949 bonds held by French and US citizens.

I am taking advantage of your present review of credit rating agencies activity to bring to your attention two extremely well researched documents prepared by Sovereign Advisers, a private financial analysis and investment research firm, which highlight the obvious failings of the main rating agencies in properly assessing the PRC's rating, and the probable reasons for their conduct.

The reason I am bringing these documents to your attention is that the same reasoning can be strictly applied to the rating of the Russian Federation. The documents can be found at the following URLs:

1: www.globalsecuritieswatch.org/Chris.Dodd.ref.binder.Sept2007.pdf (8.9 MB)
2: www.globalsecuritieswatch.org/newswire.pdf

Having briefly highlighted the fact that both the Russian Federation and the PRC have been attributed erroneous ratings, not through lack of knowledge but on the contrary despite full knowledge of a "selective default" situation, I would now like to explain why, in my view, this is so.

It is public knowledge that market liberalisation in both countries has resulted in the issue of Russian and Chinese securities on international markets. In particular, Russian and Chinese private and public corporations have been borrowing in increasingly massive quantities over the past years, and the necessary rating process of each issuer (without which foreign investors would be very reluctant to lend) has resulted in massive windfall profits for the rating agencies. It is crucial to understand that it is not the custom to rate a country's private issuer better than that country's government. Thus, no Russian corporation can be attributed a better rating than the Russian Federation itself. Therefore, if the agencies had attributed Russia the rating it quite obviously deserves, i.e. "selective default", they would have forfeited a massive source of revenue and profits since a Russian issuer could not have hoped for a better rating than "selective default" and would therefore have refrained from requesting a requesting a rating, knowing that no foreign investor would be ready to lend on the basis of a "selective default" rating. Since it is the rated entity that pays for the rating, there would have been no revenue for the agencies. The same goe s for the PRC and Chinese companies.

Although the matter discussed above - ratings attributed to defaulted sovereign issuers - is somewhat removed from the sub-prime mortgages and asset backed securities ratings causing the current market turbulence I believe that both matters stem from very similar conflicts of interest, that they both have a bearing on hundreds of billions of dollars of outstanding debt, and are therefore both worthy of your immediate attention. I think it relevant to remind you that in Sotchi on September 22nd 2007 President Putin confirmed a 1000 billion dollar modernisation programme, specifying that "in (his) view private investors, both national and foreign, will participate", while Mr. Ivanov, interim deputy Prime Minister, added that "additional tools will guarantee a high level of return on investment". Without a "selective default" rating, investors will be misled into believing the Russian government and its government entities honour their outstanding debt more than they actually do.

As one of the 316,000 French holders of defaulted Russian government bonds, the outstanding value of which is conservatively estimated to be in excess of US$ 90 billion (the outstanding amount owed by the PRC to US citizens being I believe in the hundreds of billions of US dollars), I respectfully urge you to include the matter of the ratings attributed to defaulted sovereigns - and specifically to the Russian Federation and the PRC - in the scope of your examinations, with a view to obtaining that by reflecting the unwillingness to pay, the ratings of defaulted governments and government entities accurately inform the investment community as to the track record of these issuers and the potential risks to which future investors will be exposing themselves, risks which at present are negated by the rating agencies in violation of their own self-imposed metrics, as is made abundantly clear in the first of the two documents mentioned above.

Thank you for your attention.
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See also: Institutional Approval of Lawlessness

http://www.robertamsterdam.com/2007/07/institutional_approval_of_lawl.htm
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See also the following:

http://www.ejcl.org/113/article113-16.pdf
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Readers may be interested in the following extract from a speech delivered on Nov. 21st to the European Parliament's Annual Conference of the Mortgage Federation by Pervenche Beres, Chairman of the EP's Economic and Monetary Affairs Committee.

The bold characters are from Mme. Beres.

"III. **Third** - **rating agencies**. The Capital Requirements Directive has further strengthened the role of **rating agencies**. Rating agencies perform a **public role**. Ratings are essential components of risk assessment processes under the Basle II regime. Transparency of rating processes and valuation techniques, their reliability and the solidity of ratings must be assured! The still continuing financial turmoil has highlighted **several concerns about rating agencies** that we have **already voiced**: conflict of interest, governance, reliability of ratings, and rating of complex financial products. Transparency and understanding of underlying risks in particular of complex financial products needs to be considerably enhanced!"

The full text is to be found at:

http://pervenche-beres.fr/uploads/File/update/update%20nov/Eur%20Mortgage%20Federation%2021%20November%20final.pdf
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To: the Economic and Monetary Affairs committee.

Madam Chairman,
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