

REGULATION OF CREDIT RATING AGENCIES

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Overview

- IOSCO Code of Practice
- EU Regulation on the regulation of rating agencies
 - registration framework
 - applicability to issuers/ratings outside the EU
 - rules relating to conflicts, governance, transparency and disclosure
- Regulation of rating agencies in the U.S.
- Other initiatives including:
 - SIFMA task force
 - ESF/EFAMA/IMA guidelines
- What next under the EU Regulation?

IOSCO Code of Practice

- Published in December 2004 and updated in May 2008
- Voluntary code of practice, adhered to by certain CRAs, including S&P, Moody's and Fitch, setting out desired standards of conduct in credit rating processes
- In March 2005, CESR advised European Commission that CRAs should not be regulated at a European level, but their implementation of the Code should be monitored
- From December 2005, CESR and the main CRAs operating in Europe agreed a framework for CESR to monitor their implementation of the Code and report annually to the European Commission

IOSCO Code of Practice (cont.)

- Quality of Process
 - rigorous methodologies, applied consistently
 - maintenance of internal records
 - devote sufficient resources to rating process
 - make clear any shortcomings in ratings, for instance due to limited historical data on a particular structure
 - rigorous review function of existing methodologies/models
 - assessment of whether existing models/methodologies remain adequate for new products/situations and whether complexity of structure or lack of data are such that CRA should refuse to issue a rating

IOSCO Code of Practice (cont.)

- **Monitoring/Updating**
 - adequate resources dedicated to monitoring/updating ratings
 - reviews should be regularly performed, as well as after material changes or material new information
- **Integrity of Process**
 - CRA should not give assurance/guarantee of a particular rating prior to rating assessment (should not preclude developing prospective assessments used in structured finance transactions)
 - CRA's analysts should be prohibited from making proposals/recommendations regarding design of structured finance products – does this prohibit normal interactive process?

IOSCO Code of Practice (cont.)

- Independence/Conflicts of Interest
 - maintain both substance and appearance of independence and make assessments without regard to effect on issuers/transactions
 - ensure determination of credit rating not affected by factors other than those relevant to credit assessment, including any actual/potential business relationship with the issuer
 - operationally separate credit rating business and analysts from its consulting and other businesses
 - specify what it does/does not consider to be its ancillary business and why and ensure procedures in place to minimise possibility of conflicts of interest arising with its ratings business

IOSCO Code of Practice (cont.)

- CRA Procedures/Policies
 - adopt written internal procedures/mechanisms to identify, and eliminate/manage and disclose, conflicts of interest
 - disclose general nature of compensation arrangements with rated entities, including proportion of its fees for non-rating services compared to fees for rating services, whether it receives 10% or more of its revenue from a single issuer/originator/arranger
 - encourage structured finance issuers/originators to publicly disclose all relevant information so that investors and other CRAs can conduct their own analysis
- Analyst/Employee Independence
 - Analyst compensation not linked to revenue generated from ratings
 - Analysts may not be involved in fee discussions with CRA clients
 - Employees must exclude themselves from rating process if they have a direct or indirect interest in the rated entity (such as a shareholding)
 - Employees prohibited from accepting gifts exceeding a minimal value from anyone with whom CRA does business
 - Analysts must disclose personal relationships that create actual/potential conflicts of interest
 - CRA should review past ratings conducted by analysts who leave the CRA to join an entity rated by the analyst

IOSCO Code of Practice (cont.)

- Transparency and Timeliness of Ratings Disclosure
 - distribute its ratings decisions promptly
 - indicate when the rating was last updated
 - indicate the principal methodology used and where a full description of the methodology can be found
 - except for private or subscription-based ratings, publish ratings of publicly-issued securities, as well as sufficient information about the procedures and methodologies and assumptions for outside parties to understand how the rating was arrived at
 - for structured finance products, this should include details of its loss and cashflow analysis, the degree of sensitivity of the rating to changes in the CRA's underlying assumptions. Also, Code recommends differentiating ratings of structured finance products from corporate bond ratings
 - prior to issuing/revising a rating, give issuer opportunity to correct any factual inaccuracies on which rating is based
 - publish historical default rates of different rating categories
- Other Provisions
 - maintaining confidentiality of confidential information
 - disclose to the public existence of IOSCO Code and any deviations of the CRA from the Code and reasons therefor

EU Regulation - Background

- July 2008 – McCreevy describes IOSCO code as “toothless wonder”
- EU Consultation papers published in July 2008
- Mixed reaction to consultation papers
- EU draft regulation published on 12 November 2008
- Following further consultation and negotiation, the Regulation was finally approved on 23 April 2009

EU Regulation - Overview

- Principal features of the Regulation include
 - mechanism for registration and surveillance of CRAs
 - effect of ratings issued by CRAs registered under the Regulation
 - rules relating to conflicts of interest /independence
 - rules relating to transparency and disclosure
 - imposition of organisational and operational requirements
- CRAs have six months before applications can be submitted and existing CRAs must submit their application within nine months

EU Regulation – Overview (cont.)

- Regulation applies to all ratings publicly disclosed or distributed by subscription
- Regulation does not apply to private ratings if:
 - produced pursuant to an individual order provided exclusively to the person making order and
 - the rating is not intended for public disclosure or disclosure by subscription

EU Regulation - Registration

- The application for registration is submitted to CESR
- CESR transmits copies of the application to the competent authorities of all member states and provides advice to the competent authority of the applicant CRA's home member state as to the completeness of the application
- A supervisory college shall be established with respect to each application comprising any member state which wishes to join the college provided that a branch of the CRA is established in its jurisdiction or the use of ratings issued by the CRA for regulatory purposes is widespread or has or is likely to have a significant impact on its jurisdiction
- The members of the supervisory college will appoint one member to be a facilitator who will liaise with CESR in relation to the application and will chair meetings of the college and co-ordinate their actions

EU Regulation – Registration (cont.)

- The competent authority of the CRA's home member state and the other authorities who form the supervisory college will jointly examine the application for registration and seek to reach agreement on whether to grant or refuse registration
- In the absence of agreement, a report of the various views of the college is submitted to CESR which will express its views on whether the application should be granted. The college is then required to re-examine its decision.
- In the absence of an agreement, the request will be refused

EU Regulation – Withdrawal of Registration

- The competent authority of the CRA's home member state is required to withdraw its registration where the CRA
 - expressly renounces the registration
 - has provided no credit ratings for six months
 - obtained the registration by false statements or other irregular means
 - no longer meets the conditions under which it was registered or
 - has seriously or repeatedly infringed the provisions of the Regulation
- If the competent authority considers one of these conditions has been met, it must notify the facilitator of the supervisory college
- The members of the college will carry out a joint assessment and seek to reach an agreement on whether to withdraw the registration
- The home member state may and shall if requested by any other member of the college, seek the views of CESR
- In the absence of an agreement, the home member state may proceed with the withdrawal of the registration

EU Regulation – Surveillance by Competent Authorities

- In carrying out their duties, competent authorities are not permitted to interfere with the content of credit ratings or the methodologies
- Competent authorities have wide powers to require documents or other data, interview individuals or carry out on-site inspections
- Competent authorities have wide powers including:
 - withdrawal of the registration, subject to the provisions specified above
 - the power to impose a temporary prohibition of the CRA issuing credit ratings (either a total suspension or a suspension of the use for regulatory purposes)
 - requiring the CRA to take measures to comply with their requirements
 - issuance of public notices where a CRA breaches its obligations
- Competent authorities should consult the college of supervisors before taking any such action although the ultimate decision lies with the competent authority of the home member state
- Competent authorities are required to cooperate with each other and exchange relevant information

EU Regulation – Use of Ratings

- Credit institutions, investment firms, UCITs funds, insurance/reinsurance undertakings and pension funds may only use a credit rating for regulatory purposes if issued by a CRA located and registered in the EU
- Credit rating issued by a CRA outside the EU may be endorsed by an EU registered CRA if certain conditions are met including
 - the CRA issuing the rating is in the same group as the endorsing CRA
 - the endorsing CRA can demonstrate on an ongoing basis the issuing CRA meets requirements at least as stringent as the Regulation in relation to independence, conflicts of interest, rating analyst requirements, methodologies and disclosure
 - there is an objective reason for the rating being issued outside the EU
 - the CRA is authorised or registered and subject to supervision in the jurisdiction in which it is located
 - such jurisdiction has co-operation arrangements with the relevant EU jurisdiction and its regulatory regime prevents interference of the competent authorities with the content of credit ratings and methodologies
- CRA must not use endorsement as a means of avoiding the requirements of the Regulation and remain responsible for ratings they endorse

EU Regulation – Use of Ratings (cont.)

- Ratings issued by entities located outside the EU or ratings of securities issued in a non-EU jurisdiction and not rated or endorsed by an EU registered CRA may still be used in the EU if:
 - the relevant CRA is authorised or registered and subject to supervision in its home jurisdiction
 - the EU Commission has determined the legal and supervisory framework of such jurisdiction is equivalent to those in the Regulation
 - the ratings are not of systemic importance to the financial stability or integrity of the financial markets of any member state
 - there are appropriate cooperation agreements between the authorities of the issuing CRA's home jurisdiction and the relevant EU jurisdiction
 - the issuing CRA is certified in the EU

EU Regulation – Use of Ratings (cont.)

- Certification process is similar to registration process described below and is therefore an onerous obligation
- The relevant supervisory college may however exempt the relevant CRA from certain organisational requirements or from having a physical presence in the EU depending on the nature, scale and complexity of its business, the nature and range of issuance of its credit ratings and the impact of such ratings on the financial stability or integrity of the financial markets of any member state
- A prospectus issued under the Prospectus Directive must state whether or not any credit ratings are issued by a CRA registered under the Regulation

EU Regulation – Independence and Conflicts of Interest

- CRAs are required to take all necessary steps to ensure a credit rating is not affected by an existing or potential conflict of interest
- Annex I of the Regulation sets out detailed organisational and operational requirements aimed at achieving these objectives
- The CRA's home member state may relax these requirements in relation to certain requirements if the CRA meets specified criteria

EU Regulation – Independence and Conflicts of Interest (cont.)

- Organisational requirements include:
 - CRAs must have an administrative or supervisory board which shall ensure independence of credit rating activities and that conflicts are properly identified, managed and disclosed
 - at least one third (and a minimum of two) members of such board are independent members not involved in credit rating activities (and their compensation must not be linked to the performance of the CRA)
 - CRAs must have sound administrative and accounting procedures and internal control and risk management systems
 - CRAs must establish and maintain an independent compliance function
 - effective organisational and administrative arrangements must be put in place to prevent, identify and eliminate or manage conflicts
 - an independent review function must be established to review methodology, models and key ratings assumptions

EU Regulation – Independence and Conflicts of Interest (cont.)

- Operational requirements include:
 - the identification and elimination or management and clear and prominent disclosure of actual or potential conflicts that may influence the analysis and judgement of its rating analysts or others involved in the issuance of ratings
 - public disclosure of rated entities (or related parties) from which it receives more than 5% of its annual revenue
 - it must not issue a rating in relation to any entity in which it holds financial instruments directly or indirectly (except through diversified collective investment schemes or managed funds) or to which it is affiliated
 - a CRA must not provide consultancy or advisory services regarding the corporate or legal structure, assets, liabilities or activities of the rated entity or a related party
 - analysts or persons approving ratings must not make proposals or recommendations, formally or informally, regarding the design of structured finance instruments the CRA is rating
 - rules relating to records and audit trails being maintained

EU Regulation – Rating Analysts

- Rating analysts and other persons involved in credit ratings must have appropriate knowledge and experience for the duties assigned
- Such persons must not be involved in fee negotiations with the rated entity or a related person
- Compensation and performance evaluation of analysts and persons approving ratings must not be contingent on revenue the CRA derives from rated entities or related parties
- There must be a rotation mechanism with regards to rating analysts and persons approving ratings (on the basis of individuals, not complete teams)
- There are restrictions on analysts and persons involved in credit ratings buying or selling financial instruments issued or guaranteed by a rated entity within their responsibility or of being involved in the rating of any entity in which they hold financial instruments
- Analysts and persons involved in credit ratings must not solicit or accept money, gifts or favours from anyone with whom the CRA does business

EU Regulation – Methodologies, Models and Key Rating Assumptions

- CRAs must make public disclosure of their methodologies, models and key ratings assumptions
- CRAs must monitor credit ratings and review their credit ratings and methodologies on an ongoing basis and at least annually and where changes occur that could have an impact on a credit rating
- Where methodologies, models or key rating assumptions change, CRAs must disclose the ratings likely to be affected and review and re-rate such ratings as soon as possible (and not later than 6 months after the change)
- Outsourcing of important operational functions shall not be undertaken in a way to impair materially the CRA's internal controls and the ability of the relevant competent authority to supervise its compliance with the Regulation

EU Regulation – Disclosure and Transparency Obligations

- CRAs are required to disclose credit ratings (including those distributed by subscription) and any decision to discontinue a rating on a non-selective basis and in a timely manner
- Ratings for structured finance instruments must be clearly differentiated using an additional symbol which distinguishes them from other ratings
- CRAs must disclose their policies and procedures regarding unsolicited ratings and unsolicited ratings must be disclosed as such and indicate whether the rated entity participated in the process and whether the CRA had access to its accounts or other relevant documents
- There are various rules relating to the presentation of ratings including:
 - the lead analyst must be disclosed
 - disclosure requirements in relation to sources and rating methodologies
 - any specific attributes and limitations of the ratings
 - specific requirements in relation to structured finance instruments including disclosure of all information about its loss and cash flow analysis

EU Regulation – Periodic Disclosure

- CRAs must fully and publicly disclose and keep updated certain information including:
 - any actual and potential conflicts of interest
 - its policy concerning the publication of credit ratings and related communications
 - the general nature of its compensation arrangements
 - descriptions of rating methodologies, models and key ratings assumptions and material amendments to these
 - its code of conduct
- CRAs must also make available historical performance data (including ratings transaction frequency and ratings changes) in a central repository established by CESR available for public inspection
- Certain information relating to its largest 20 clients by revenue must be provided periodically to its home competent authority
- CRAs must also publish an annual transparency report

EU Regulation – Excessive Reliance on Credit Ratings

- According to the Financial Stability Forum, “some institutional investors have relied too heavily on ratings in their investment guidelines and choices, in some cases fully substituting ratings for independent risk assessment and due diligence. Some also relied exclusively on ratings for valuation purposes”.
- European Commission outlined three proposals:
 - requiring regulated and sophisticated investors to rely more on their own risk analysis, especially for large investments
 - requiring that all published ratings include “health warnings”
 - examining the regulatory references to CRA ratings and revisiting them as necessary

EU Regulation – Excessive Reliance on Credit Ratings (cont.)

- De Larosi re report highlighted over-reliance by investors on credit ratings as a key issue and recommends fundamental review of “hardwiring” of ratings with a view to significantly reducing the use of ratings in financial regulations over time
- Turner Review and FSA Discussion Paper also expressed concern on level of investor reliance on credit ratings and highlighted:
 - the use of “ratings triggers” in financial instruments
 - the level of integration of ratings into investment mandates
- US White Paper also states that investors were overly reliant on credit rating agencies and recommends that regulators should reduce their use of credit ratings in regulations and supervisory practices where possible

Regulation of CRAs in the U.S.

- Nationally Recognized Statistical Rating Organizations (“NRSRO”s)
- Credit Rating Agency Reform Act 2006 establishes
 - registration process
 - annual certification process
 - oversight by SEC
 - other requirements on NRSROs including record-retention and financial reporting
- Rule changes proposed by SEC in June 2008, finalised in December 2008 and revised in February 2009

Conflicts of Interest

3 absolute prohibitions

- NRSRO cannot issue a rating if its personnel or affiliates have made recommendations on corporate or legal structure, assets or liabilities of an issuer
- NRSRO cannot issue a rating if the personnel involved in the rating process have participated in fee discussions/ negotiations (unless exempted by SEC)
- NRSRO analyst who has participated in credit rating of an issue may not receive gifts (other than of a de minimis value in context of normal business activities) from issuer, underwriter, sponsor or guarantor of rated securities

Conflicts of Interest (cont.)

Restrictions on “issuer-paid” ratings

- NRSRO may not issue a rating, where rating is paid for by issuer/arranger/sponsor/guarantor, unless various information is disclosed publicly
 - random sample of 10% of ratings (and their histories, including withdrawals) in each class for which they are registered with SEC (provided they have issued 500 or more ratings in that class) to be disclosed on CRA’s website no later than 6 months after rating given
 - “class” when it comes to asset-backed securities, must include all structured finance products – includes RMBS, CMBS, CDOs, CLOs
 - includes “withdrawals”
- SEC has proposed requiring disclosure of ratings/actions for all ratings issued after June 2007, within 12 months after the relevant rating action. It is also seeking comments on whether public disclosure should be applied to subscriber-paid credit ratings

Reporting and Disclosure

- NRSRO must disclose:
 - performance measurement statistics and the procedures and methodologies used by it in determining ratings for structured finance products and for other debt securities
 - transition statistics for each asset class of credit ratings for which an NRSRO is registered with SEC, broken down into 1, 3 and 10 year periods
 - all upgrades and downgrades, as well as default statistics
- NRSRO must, in its description of its procedures and methodologies, address:
 - whether, and if so how, verification performed on underlying assets is relied on in determining the credit rating
 - whether, and if so how, assessment of the quality of the originators of the underlying assets play a part in the determination of the ratings
 - its surveillance process, including frequency of review of ratings and whether different models or criteria are used for surveillance, compared to initial rating

Record-keeping Requirements

- NRSRO is required to maintain records of:
 - all ratings actions, including initial ratings, upgrades, downgrades, placement on watch lists
 - all written communications regarding complaints about performance of credit analysts and NRSRO's response
 - where quantitative model is substantial component of process of determining a structured product's rating, reasons for any material difference between credit rating implied by the model and the final rating issued
 - communications related to the monitoring of ratings

What was not included in the SEC's Final Rules

- No differentiation required of credit ratings of structured instruments and products, compared to corporate bonds
- No detailed proposals as to amendments to the (approximately 30-40) other SEC provisions referencing ratings by NRSROs

Asset Management Industry Guidelines Regarding Over-reliance upon Ratings

- EFAMA, ESF and IMA published guidelines in December 2008 to answer a request from Financial Stability Forum that investor associations should address over-reliance upon credit ratings in the course of investing in structured products
- Written from viewpoint of asset managers acting on behalf of pension funds, UCITS, insurers, corporates and hedge funds in respect of a broad range of structured finance and structured credit products
- Expressed views that the ability of asset managers to address any over-reliance depends on quality and extent of information from issuer
- Asset managers must act competently, diligently, professionally in best interest of clients and develop clear, consistent investment processes
- They shall require originators/arrangers to provide them with all necessary information
- Ratings should not replace appropriate risk analysis and risk management on behalf of investors. Credit ratings assess creditworthiness, not liquidity or market risk, nor should they be used as a basis for decisions regarding diversification or valuation
- Asset managers must understand the methodology and competences of the relevant rating agency and must be aware of the information not generally available to investors, including expected loss distributions of structured products

SIFMA Task Force

Task Force (comprised of 37 individual firms)

- is not in favour of “ratings modifiers” or removal of ratings from regulatory references, or the prohibition of the “iterative” process in structured finance ratings
- has concerns about “mutually exclusive” aims of two proposed measures in EU
- is concerned about overly-prescriptive EU Regulation - “intrusive, inflexible, inefficient and economically burdensome”
- has concerns over lack of global co-ordination
- agrees with some proposed measures to discourage excessive reliance on ratings such as disclaimers

Other views

- ESME – ratings have been unsatisfactory in structured finance area. However, did not recommend new legislation, but instead an enhanced self-regulatory model, transparency as to CRA compliance/non-compliance. Also recommended commissioning an external annual review and report on the adequacy of each CRA's corporate governance and forming advisory group to advise CESR in performing its role of reviewing compliance with the IOSCO Code
- CESR – similarly to ESME did not recommend legislative measures. Found no evidence that regulation of CRAs would have had a positive effect on recent market turmoil. Supported market-led improvement, with modified IOSCO Code and establishment of monitoring agency with power to “name and shame” those CRAs not meeting the standards of the Code, thus effectively enforcing compliance

What next under the EU Regulation?

- Excessive reliance on ratings
 - will any legislation emerge to address this?
 - does the CRA Regulation have exactly the opposite effect?
 - will market-led initiatives (eg. EFAMA guidelines) promote more appropriate investor-side procedures?
- Global consistency
 - how will CESR assess equivalence of other jurisdictions, given the CRA Regulation is so specific – particularly the US
 - Commission to report in 1 year as to co-operation of supervisory authorities and developments in CRA regulation/supervision in countries outside EEA
- Is the “issuer-pays” model under threat?
 - Commission to report in 3 years

Any Questions?

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