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accompanying the

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on Credit Rating Agencies

IMPACT ASSESSMENT

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1. INTRODUCTION

Credit rating agencies (CRAs) play a vital role in global securities and banking markets: they issue creditworthiness opinions that help to overcome the information asymmetry that exists between those issuing debt instruments and those investing in these instruments. It is essential, therefore, that they consistently provide ratings which are independent, objective and of the highest possible quality. The Commission will present in autumn 2008 its policy response in relation to the role that CRAs have played in the recent financial turmoil. This document reflects the impact assessment carried out by the Commission services to determine this policy response.

1.1. Role of CRAs and importance of ratings.

CRAs are companies recognised in the markets as independent providers of credit opinions (ratings). For the most part of the last century the main business of these companies was to perform analyses and issue opinions on the probability of default or expected losses of other companies ("corporate") and governments ("sovereign"). However, over the last few decades these companies have engaged in providing ratings for a wide range of more complex financial instruments, known as structured finance products.

CRAs have a major impact on the financial markets, with their ratings actions closely followed by investors, borrowers, issuers and governments. Investors refer to ratings as a key piece of information to determine their investment decisions, depending on the risk they are willing to assume. The rating given to issuers and securities will affect the cost of raising capital. Very often deterioration of a debtor's creditworthiness concluded in a rating may trigger particular contractual obligations (e.g. immediate debt repayment). Finally, there are references to credit ratings in financial regulation: the most prominent example is the Capital Requirements Directive¹, under which credit institutions are entitled to use the ratings as one of the references for the calculation of their capital requirements for solvency purposes.

Over the last decade CRAs have attracted the attention of policymakers on a number of occasions, coinciding with the times of tension in financial markets. Regulators worldwide turned their attention to the role of CRAs following their failure to weather the difficulties of Asian economies in July 1997 and the corporate collapses at the beginning of this century notably in the EU and the US (Enron, Worldcom, Parmalat).

Against this background and following the resolution on CRAs adopted by the European Parliament in February 2004², the Commission considered very carefully whether legislative measures would be necessary to regulate the activities of CRAs. In line with the advice received from the Committee of European Securities Regulators (CESR) in March 2005³, the

¹ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast). OJ L 177, 30.6.2006, p. 1–200. An explanation on the Directive could be found in annex 9.1.

² European Parliament resolution on Role and Methods of Rating Agencies (2003/2081(INI)).

³ CESR's technical advice to the European Commission on possible measures concerning credit rating agencies, CESR/05/139b, March 2005. CESR is an independent advisory group to the European Commission composed by the national supervisors of the EU securities markets. The Committee was established by the European Commission's Decision of 6 June 2001 (Commission Decision of 6 June 2001, establishing the Committee of European Securities Regulators, 2001/527/EC, OJ L191, 13.7.2001, p.43). The role of CESR is to improve co-ordination among securities regulators, act as an

Commission decided not to present new legislative proposals in the area of CRAs considering that the existing financial services directives applicable to CRAs would provide an answer to all the major issues of concern raised by the European Parliament (for an overview of the EU regulatory framework for CRAs see annex 9.1).

In this context, the Commission adopted in 2006 a Communication on Credit Rating Agencies⁴; in this Communication the Commission concluded that various financial services directives, combined with self regulation by the CRAs themselves on the basis of the Code of Conduct Fundamentals for CRAs of the International Organisation of Securities Commissions (IOSCO)⁵, could provide a satisfactory answer to the major issues of concern in relation to CRAs. It was stated that this approach would require continuous monitoring of developments in this area by the Commission. In addition, the Commission asked CESR to monitor compliance with the IOSCO Code and report back on an annual basis.

The Commission indicated in the Communication that it might consider putting forward legislative action if it became clear that compliance with EU rules or IOSCO's code was unsatisfactory or if new circumstances were to arise – including serious problems of market failure or significant changes in the way CRAs are regulated in other parts of the world.

1.2. The financial crisis, the role of CRAs and the ECOFIN Roadmap

Since August 2007 financial markets worldwide are suffering from a major confidence crisis. The crisis originated in the US residential subprime mortgage market and subsequently developed into other sectors of the financial markets.

This financial crisis is a complex phenomenon that involved multiple actors. Subprime mortgages were offered to homebuyers with suboptimal credit situation (and thus higher risk of payment defaults) and made subject to less demanding underwriting standards. A large number of these mortgages were then normally grouped in pools of assets and transformed in a securitisation process into new financial instruments (structured products)⁶ that were sold in the financial markets worldwide. Often these instruments were rearranged in new complex innovative financial structures and sold to investors like banks, investment funds, pension funds, insurance companies and other professional investors. Over 80% of these subprime structured products were rated with the highest ratings by the CRAs. (For an extended explanation on the financial crisis see Annex 9.2.).

advisory group to assist the EU Commission and to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.

⁴ Communication by the Commission on Credit Rating Agencies, 11.3.2006 (2006/C 59/02), OJ C59, 11.3.2006, p.2.

⁵ The International Organisation of Securities Commissions (IOSCO) is an international non mandatory standard setting organisation composed of securities markets supervisors. Securities markets supervisors cooperate within IOSCO in order to promote high standards of regulation aiming at maintaining just, efficient and sound securities markets.

⁶ The original lenders of sub-prime loans bundled the mortgage loans together and sold them to investors as mortgage backed securities – in essence these investors bought securities that would entitle them to a return from these mortgages in return for taking on all or part of the risk. These securities were rated by credit rating agencies and then sold to other financial institutions and investors. The process of packaging and pooling assets like mortgage loans, and selling them to investors as securities is referred to as 'securitisation'. Banks transferred most of these mortgage assets to off-balance sheet entities (so-called structured investment vehicles or SIVs), which financed themselves via short-term loans. This made them vulnerable to a sudden financing disruption if those providing the loans were to lose confidence, which is exactly what happened in August 2007.

This turmoil has hit Europe through three different channels. Firstly, some EU financial institutions faced losses because they were exposed to the US sub-prime market, e.g. through credit lines on special purpose vehicles that had bought US sub-prime securities (In accordance with data from Bloomberg in mid May, since the beginning of 2007 the biggest banks and securities firms have faced \$379 billion in asset write downs and credit losses. More information can be found in the annex 9.10). Secondly, the US sub-prime problems have considerably slowed down US growth prospects. Given global trade inter-linkages this affects the EU economic growth as well. Thirdly, the general market uncertainty has eroded equity market prices also in Europe as well as reduced consumer and business confidence. Illustrative data on the trend of issuance of structured finance products could be found in annex 9.11.

CRA's were close to the origin of the problems that have arisen with subprime markets: they were giving favourable opinions on instruments that were financially engineered to give high confidence to investors. The investors – relying on CRA's expertise – very often took little or no interest in the risks characteristics of these instruments, performance of underlying assets and general market outlook.

The amount of securitised products⁷ outstanding (before maturity) in Q1 2008 surpassed 6,000 billion EUR in the US, while the amount outstanding in Europe was around 1,200 billion EUR. Instruments awarded with the highest rating grade⁸ amounted to 75% of those rated by the rating agencies. Most investors, who were less familiar with the structured products and merely sought to take advantage of superior returns in these markets, normally did not look at instruments rated below that grade.

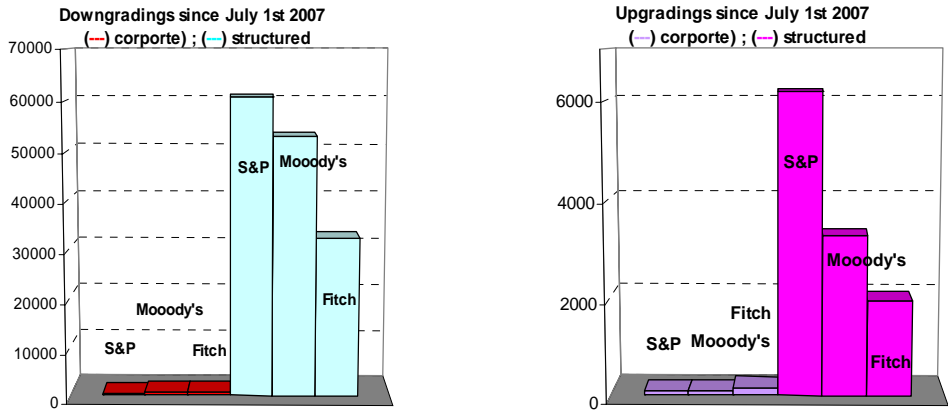
In response to worsening market outlook, faltering confidence in the financial viability of the subprime structured products and internal reassessments, over the past months CRA's have decided on downgrading of these instruments on a massive scale. Recent figures show (see Chart 1 below) that CRA's have seriously and systematically failed to assess correctly the creditworthiness of structured finance instruments, as opposed to traditional ones (corporate, sovereign). In the period between 1 July 2007 and 24 June 2008, CRA's downgraded 145,899 structured ratings compared whereas only 1,445 corporate ratings were downgraded in the same period⁹. Hence, the problem has affected most severely the structured finance segment.

⁷ These figures cover asset backed securities (ABS), commercial mortgage backed securities (CMBS), residential mortgaged-backed securities (RMBS) and collateralized debt obligations (CDO). In the case of CDOs tailor-made (typically non-public) issues and issues with a significant element of derivatives in the underlying assets are not included due to data limitations (see also Annex 9.3).

⁸ So called AAA, or triple A, i.e. top of the rating scale which is used by the CRA's to present in relative terms creditworthiness of issuers.

⁹ Source: Bloomberg.

Chart 1. Downgrades and upgrades comparison for largest CRAs - start date: July 2007



(Source: Bloomberg)

As the financial crisis evolved, a considerable increase in the ratings' changes could be observed. Table 1 below shows upgrades and downgrades for European and US structured products respectively. In the first half of 2007 the three major credit rating agencies active in this field (Fitch, Standard & Poor's and Moody's – see point 1.3) generally upgraded slightly more times than they downgraded. In the second half of 2007 as well as the first half of 2008 this changes dramatically. The overall number of rating changes increases as well as the relationship between the number of upgrades and downgrades, although the change in Europe is not as strong as in the US. In the second quarter of 2008 the total number of upgrades for European and US securitised products was 659, while the number of downgrades amounted to 28700.

		2007:Q1	2007:Q2	2007:Q3	2007:Q4	2008:Q1	2008:Q2
EU	Fitch	116 / 19	78 / 12	124 / 44	163 / 139	36 / 61	33 / 159
	Moody's	101 / 38	62 / 42	38 / 76	81 / 94	22 / 257	67 / 655
	S&P	126 / 65	81 / 72	92 / 77	83 / 145	50 / 512	65 / 657
	Total	343 / 122	221 / 126	254 / 197	327 / 378	108 / 830	165 / 1471
US	Fitch	654 / 221	637 / 643	335 / 2053	132 / 3099	335 / 4901	165 / 5763
	Moody's	447 / 158	279 / 380	562 / 1619	315 / 7498	111 / 4751	223 / 16563
	S&P	418 / 194	414 / 372	407 / 1230	292 / 4741	216 / 8895	106 / 4903
	Total	1519 / 573	1330 / 1395	1304 / 4902	739 / 15338	662 / 18547	494 / 27229

Source: European Securitisation Forum. Securitisation Data Report Q2:2008, p. 10

The massive downgrading of securitised products further undermined the market's confidence in the ratings produced by CRAs. This massive downgrading would also suggest that the rated products have been construed in such a way that they have narrowly met the criteria for a certain rating at the time of issuance and/or the assessment of the probability of default or expected loss was unrealistic.

CRAs failed to reflect early enough in their ratings the worsening of market conditions. The explanation for this poor performance by CRAs could be found in the unsatisfactory way the agencies manage their conflicts of interest, the lack of quality of the ratings they issued, the need for improved transparency of the agencies and the inappropriate internal governance. The subprime debacle demonstrated that the existing framework for the operation of CRAs needs to be significantly reinforced.

As indicated above, CRAs cannot be blamed alone for the current financial turmoil; other actors and special circumstances concurred in the events that led the financial markets to the crisis. As a consequence, in close cooperation with the European Commission, the EU Finance Ministers in October 2007 unanimously agreed to a set of conclusions to respond comprehensively to the main weaknesses identified in the financial system. These initiatives, which are consistent with the agenda set at global level, are grouped into the so-called "ECOFIN roadmap". The Spring Council of March 2008 endorsed the policy areas of the roadmap and stated that authorities in the EU should "*stand ready to take regulatory and supervisory action were necessary*"¹⁰. The roadmap combines different actions of a regulatory and non-regulatory nature which are structured around four main objectives:

- Improve transparency in the market, notably with respect to banks' exposures relating to securitisation and off-balance sheet items;
- upgrade valuation standards to respond in particular to the problems arising from the valuation of illiquid assets;
- strengthen the prudential framework for the banking sector, including the treatment of large exposures, banks' capital requirements for securitisation, and liquidity risk management;
- investigate structural market issues, such as the role played by CRAs and the "originate and distribute" model.

Therefore, this Impact Assessment focuses only on the last of the Council requests where the Commission has to examine the role of CRAs and the uses of credit ratings, in particular as regards structured finance instruments, conflicts of interest, transparency of rating methods, time-lags in rating reassessments and regulatory approval processes.

1.3. Overview of CRAs market

The credit rating market is oligopolistic and is effectively dominated by three big entities operating globally: Standard & Poor's, Moody's Investors Service and Fitch Ratings. Moody's and Standard & Poor's have a combined market share in excess of 80%, while Fitch's market share is approximately 14%. These entities have their head office and main

¹⁰ Presidency Conclusions of the Brussels European Council (13/14 March 2008).

management, administrative and supervisory bodies in the US. They operate in the EU through subsidiaries established in several countries¹¹. Their activity does not have a territorial character.

Moody's Investor Services is owned by Moody's Corporation (listed in New York Stock Exchange - NYSE). Standard & Poor's is owned by the American publisher Mc Graw-Hill (which is a listed entity at NYSE). Fitch is dual-headquartered in New York and London and is a subsidiary of the French financial company Fimalac (listed in Euronext Paris)¹². (For more precise information about the three big CRAs please see the first part of Annex 9.4.)

Beyond these three big organisations, the CRA landscape is occupied by a number of smaller players, often catering to very specific market needs. Among them, Dominion Bond Rating Service (DBRS)¹³, Japan Credit Rating Agency, Ltd. and Rating and Investment Information, Inc. are well established regional players (in Canada/US and Japan respectively) with ambitions to develop their international market presence. Finally, there are a number of local rating agencies active in different countries, issuing rating opinions both for general purposes and for specialized uses; their impact on the global financial markets is nonetheless marginal (for a comprehensive list of CRAs, see the second part of Annex 9.4).

Over the past years, there has been a major shift in the revenue structure of the leading CRAs. Until the mid-nineties CRAs specialised in and derived most of their revenues from the rating of corporate or sovereign debt. However, with the growth of structured markets they increasingly engaged in the highly lucrative rating activity of new structured finance transactions. As a consequence CRAs currently earn approximately 50% of their revenue from structured finance ratings.¹⁴

1.4. The legal framework for CRAs

At present, Community law addresses only specific aspects relevant to the activity of the rating businesses (basically measures included in the Market Abuse Directive¹⁵ and the Capital Requirements Directive¹⁶). CRAs are not required to seek authorisation or to register

¹¹ Standard & Poor's has subsidiaries in France, Germany, Italy, Spain, Sweden and UK; Moody's has subsidiaries in Bulgaria, Cyprus, Czech Republic, France, Germany, Italy, Spain and UK. Fitch has subsidiaries in UK ("Fitch Europe"), France, Germany, Italy, Poland and Spain.

¹² Fitch merged in 1997 with the British IBCA rating company, which is specialised in rating banks. Fitch-IBCA then bought the fourth-largest American rating agency, Duff & Phelps, in June 2000 and, in December 2000, Thomson BankWatch, another agency specialised in rating banks.

¹³ DBRS has its headquarters and main offices in Toronto. DBRS opened offices in Paris (in early 2006), in London (September 2005) and Frankfurt (December 2005) and sought to compete for market share in Europe on offering research and ratings on banks and securitisation. Due to adverse economic conditions, in January 2008 DBRS announced that they were closing all their EU offices.

¹⁴ In accordance with a Report on rating agencies published by the French Autorité des Marchés Financiers for 2006 the ratings income of the agencies in Europe represented in 2006 between 16% and 30% of worldwide income, with transactions in the United States representing more than half of the income of the agencies. Structured finance business represented between 35% and 45% of European earnings.

¹⁵ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation OJ L 96, 12.4.2003, p. 16

¹⁶ Article 80 *et seq* of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions OJ L 177, 30.6.2006, p. 33

and they are not subject to any form of official (public or self-regulatory) oversight at EU level. For more details on the legal approach on CRAs, see Annex 9.1.

As mentioned in section 1.1, the European Commission issued a Communication on CRAs in 2006 where it concluded that various financial services directives, combined with self regulation by the CRAs themselves on the basis of the IOSCO Code, could provide an answer to the major issues of concern in relation to CRAs. The Communication stated that this approach would require continuous monitoring of developments in this area by the European Commission and additionally asked CESR to monitor compliance with the IOSCO Code and report back on an annual basis.

The Commission Communication concluded that CRAs had to incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct on a voluntary basis; CRAs are free not to respect certain obligations stemming from the Code, as long as they disclose them ("comply or explain" principle). The annual monitoring report produced by CESR is the only mechanism available in order to control the CRAs' compliance with the Code.

Conversely, CRAs operating in the US are regulated entities. They have to be registered and supervised by the US securities markets supervisor (the Securities and Exchange Commission, SEC). A description of the main elements of the US legal framework for CRAs can be found in the second part of annex 9.1. The US Act on CRAs of 2006¹⁷ is relatively recent and its effectiveness has not been tested yet; it entered into force in June 2007, just weeks before the beginning of the subprime turmoil. The SEC announced last September its intention to reinforce this framework. On 11 June and 1 July 2008 the SEC proposed important changes in the legal framework for CRAs¹⁸. These proposals are presented in more detail in the Annex 9.5 of this Impact Assessment.

2. PROCEDURE

2.1. Consultation

The European Commission decided to mandate CESR in September 2007, and the European Securities Markets Expert Group (ESME)¹⁹, in November 2007, to provide advice on the various aspects of CRAs' activity and role in the financial markets and especially in structured finance. The Commission services followed the work of both groups throughout the entire process. Both groups have carried out an extensive consultation with stakeholders notably on the role of structured finance in the context of the subprime turmoil. CESR delivered its report on 13 May 2008 and ESME delivered its report on 4 June 2008.

In addition, the Commission services have held discussions with major rating agencies and other stakeholders (industry associations from the insurance, securities and banking sectors, information providers, etc). The Commission services have also received written inputs from

¹⁷ US Credit Rating Agency Reform Act of 2006.

¹⁸ More information can be found at www.sec.gov/rules/proposed.shtml.

¹⁹ The European Securities Markets Experts Group (ESME) is an advisory body to the Commission, composed of securities markets practitioners and experts. It was established by the Commission in April 2006 and operates on the basis of the Commission Decision 2006/288/EC of 30 March 2006 setting up a European Securities Markets Expert Group to provide legal and economic advice on the application of the EU securities Directives (OJ L 106, 19.4.2006, p. 14–17).

a wide range of associations, market practitioners and stakeholders. On the international side, the Commission services have followed closely the developments like the revision of the code of conduct for CRAs approved by IOSCO on May 26 and the report of the Financial Stability Forum (FSF)²⁰ published on April 7, 2008. The Commission services have been also following the consultations carried out by both IOSCO and the FSF. Finally, the Commission took into consideration the various initiatives proposed and / or implemented by the CRAs either individually or on an industry-wide basis (among them the industry White Paper, they prepared in response to the work on the IOSCO Code revision²¹) and benefited from an intensive informal dialogue with the interested rating agencies. An overview of the main elements of these initiatives can be found in Annex 9.5.

Taking into account the global dimension of the rating business, the Commission services have thoroughly scrutinised the current legal framework for CRAs in the US, and have followed closely the evolution of the proposals for changes in the US Act on CRAs implementing measures presented by the US Securities and Exchange Commission (SEC) on 11 June and 1 July 2008. This issue has also been part of the ongoing regulatory dialogue with the US. A comparative table of the US regime, IOSCO code standards and the proposal of the Commission can be found in annex 9.12.

Additionally, the Commission has encouraged comments from interested stakeholders in a public consultation starting on 31 July and lasting till the beginning of September 2008.

The Commission services received 82 contributions: 13 from credit rating agencies, 52 from organizations of stakeholders (banks, associations, investment funds, savings banks etc) and 17 from securities regulators and ministries of finance of Member States.

The non-confidential contributions can be consulted in the Commission website (http://ec.europa.eu/internal_market/securities/agencies/index_en.htm).

2.2. Steering Group

The Steering Group for this Impact Assessment was formed by representatives of Directorate General Internal Market and Services, Directorate General Competition, Directorate General Economic and Financial Affairs, Directorate General Enterprise and the Secretariat General and met four times, on 27 June and 8, 11 and 16 July 2008. The contributions of the members of the Steering Group have been taken into account in the content and shape of this impact assessment.

²⁰ The Financial Stability Forum was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The Forum brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk.

²¹ Discussion Paper about Measures to Enhance the Independence, Quality and Transparency of Credit Ratings, endorsed by 5 rating agencies (A.M. Best, Moody's, Standard & Poor's, Fitch, DBRS). December 2007.

2.3. Impact Assessment Board

DG MARKT services met the Impact Assessment Board the 3 September. The Board analysed this Impact Assessment and delivered its opinion on 9 September 2008. During this meeting the members of the Board provided DG Markt services with comments to improve the content of the Impact Assessment that led to some modifications of this final draft. These are the most relevant ones:

- Clarifications in sections 1.2 and 3 about the financial crisis and the role of CRAs, explaining that the financial crisis is a phenomenon caused by multiple factors, and presenting the Commission proposal on CRAs as a part of a wider exercise (the ECOFIN roadmap).
- In order to highlight the synergies and differences of the proposal with US regulatory framework the section 2.1 was amended and a comparative table was incorporated to this Impact Assessment (annex 9.12).
- A summary of the main elements of the consultation was added in section 2.1, and the Impact Assessment has been consistently revised.
- More evidence for some of the elements of the problem definition was added in chapter 3.
- In order to highlight the added value of the proposal of the Commission tacking into account the revised IOSCO code of conduct and the voluntary initiatives implemented by CRAs, the structure and content of sections 5.2, 6.2.1 and 6.3 were revised.
- The substance and the two options for the supervisory architecture of the legislative option were further elaborated in section 5.2.
- Further clarifications about the assumptions used in the analysis of impacts in chapter 6 were added, in particular in relation to the convergence of the substantive policy options with the rules in the US and the standards of the IOSCO code of conduct for CRAs.
- The analysis of the legislative proposal was further elaborated in section 6.2.4.
- Some clarifications concerning the costs of the proposal were added in chapter 7, in particular in relation to the cost of the prohibition of the provision of consulting activities.
- Finally, the monitoring and evaluation strategy was further elaborated in chapter 8.

3. PROBLEM DEFINITION

The measure proposed by the Commission on CRAs does not intend to tackle all issues linked to the financial turmoil but only focuses on CRAs. Evidence shows that CRAs have had a markedly worse performance when assigning ratings to innovative, structured products than when issuing traditional ones. The analysis of the Commission therefore focuses on the issues that have arisen in the contexts of rating structured finance products. However, it has to be borne in mind that as financial innovation progresses, similar problems may occur in the future in other areas where CRAs have limited or no experience. Moreover, certain deficiencies that became evident with respect to structured finance ratings relate to the structure, business model and internal processes of the entities. Bearing this in mind, they may

also have a harmful effect on the more traditional areas of CRAs' activity. The major problems that the Commission services have identified with respect to rating agencies are grouped in three broad areas:

- Failures in the integrity of the CRAs (mainly in relation to conflicts of interest);
- unsatisfactory quality of methodologies and ratings;
- lack of transparency of the CRAs.

Moreover, the lack of effective supervision and enforcement can accentuate these problems. Contrary to the US, in the EU CRAs are not subject to direct supervision. Public authorities in the Member States are not entitled to sanction a rating agency when it breaches the current IOSCO standards of integrity, quality and transparency.

Further issues have been highlighted by stakeholders, notably the limited scope of competition among CRAs and the unfair practices, like the so called "notching practice"²². While the Commission services acknowledge the relevance of these problems, competition rules developed under the articles 81 and 82 of the EC Treaty are best placed to address these concerns. Therefore, any measure proposed will fully take into account its impact on the competition among CRAs.

Another issue out of the scope of this Impact Assessment is the question of the over-reliance on ratings by investors. A number of stakeholders have noted that many investors relied solely on the rating of a product to make up their investment decisions and did not carry out any further analysis about the risks of their investment. The Commission launched a parallel consultation about this issue on 31 July 2008. Further action may be envisaged at a later stage.

3.1. Failures in the integrity of CRAs; conflicts of interest in the rating business

All contributors, institutions and stakeholders consulted have unanimously expressed the view that the conflicts of interest that could arise when CRAs rate structured products have not been avoided or managed in a satisfactory way. The lack of independence of the agency, the influence of the remuneration aspects over the independence of the analysts, the conflicts of interest that arise from the performance of services other than rating, the influence of the analyst's relations with potential future employer and the possible "shopping" for ratings are the most relevant topics which need to be addressed.

3.1.1. Conflicts of interest originated by the "issuer-pays" model

The task of evaluating the creditworthiness of an issuer undertaken by an agency is – as a rule - paid by the same issuer who is being rated or the originator of the issue. This situation

²² "Notching refers to the practice whereby one rating agency reduces the ratings from another rating agency on structured finance collateral it has not rated itself. Notching can arise when structured finance collateral such as commercial mortgage backed securities (CMBS), residential mortgaged-backed securities (RMBS) and asset backed securities (ABS) are included in rated investment vehicles such as collateralized debt obligations (CDO), structured investment vehicles (SIV) or asset-backed commercial paper programs (ABCP)." (From Greenberg Quinlan Rosner Research Inc – www.greenbergresearch.com)

creates conflicts of interest for the agency²³. As ratings effectively translate into borrowing costs, issuers and originators would always strive to have their instruments rated at the highest possible grade. On the other side, the accuracy of the rating is under pressure as the agency makes efforts to attract business and maximise profits. Another source of conflicts of interest is the lack of independence of the CRA in relation to the issuer/originator whose financial instruments are to be rated. In a survey carried out in June 2008 the CFA Institute²⁴ asked its members (investment professionals worldwide) whether they had ever witnessed a CRA changing a rating as consequence of pressure or influence from an investor, issuer or underwriter. 211 of the 1.956 respondents said they have indeed witnessed a CRA changing ratings in response to external pressures. When asked to specify how this pressure was accomplished, 51% mentioned the threat to take future rating business to other CRAs and 17% mentioned the offer to deliver more business to the agency. When an agency is not independent its rating opinions may not be accurate. Corporate or economic links, business interests or other kind of links between the issuer/originator and the agency jeopardise the agency's independence.

There are two alternatives to the "issuer-pays" model: a "subscriber-pays" model and a "public utility" model. The "subscriber-pays" model was used by the agencies until the 1970s. There were two main reasons why the agencies abandoned such a model: firstly, the dissemination of ratings created an unlevel playing field as they did not reach all market participants (such a piece of information would only be limited to the subscribers); secondly, the model did not provide enough funding for the analysis of increasingly complex products (which required the agencies to devote more resources). On the other hand, the "public utility" model requires transforming the CRAs into a public utility and funding them with government revenues. This model has its own disadvantages: it is not free from own conflicts of interest (governments are rated entities too); it is also considered that it could severely hamper the innovation within the financial markets and it is a costly proposition involving taxpayers' money.

3.1.2. *Conflicts of interest that emerge from the agency's activities: advisory and ancillary services; the dialogue of the analysts with the rated entity*

3.1.2.1. Conflicts of interest arising from the provision of advisory services and ancillary services

One source of conflicts of interest for CRAs is the provision of services different from the rating to the issuer/originator, like advisory services. Should these non-rating services give rise to significant, high-margin revenues from a rated client, a CRA has a clear incentive to continue this lucrative relationship and look more favourably at the client's creditworthiness for rating purposes. The provision of advisory services also creates a clear conflict of interest for the CRAs, where their analysts formulate proposals or recommendations regarding the

²³ "Many observers cite the conflicts of interest inherent in the credit rating industry as a source of concern. The most common conflict noted is that many of the CRAs receive most of their revenue from the issuers that they rate. The fear is that where a CRA receives revenue from an issuer, the CRA may be inclined to downplay the credit risk the issuer poses in order to retain the issuer's business". IOSCO, The Role of Credit Rating Agencies in Structured Finance Markets – Final Report.

²⁴ CFA Institute (Chartered Financial Analysts Institute) is a global, not-for-profit association of investment professionals that manages educational programs for investment professionals and analysts and promotes ethical standards and professional excellence within the global investment community (more information in www.cfainstitute.org).

design of a structured finance instrument. In this case, impartiality of the agency and its independence become questionable: it both advises the issuer/arranger on how to structure a product and rates the probability of default of such a product.

Ancillary services are activities other than the rating process, like *pricing analysis* for structured finance securities that do not have a liquid market or *rating assessment services*, where CRAs provide issuers with the likely impact on a rating of hypothetical events (for instance a merger between two corporations), or several hypothetical structures in relation to a structured product (for instance when it comes to how different tranches of debt are set up, or when it comes to levels of credit enhancement). Provision of ancillary services may give rise to similar situations as in the case of advisory services (i.e. when ancillary service relationship prevails over the rigour and independence of the rating process).

On the one hand CRAs have not properly separated operationally and legally their analysts and credit rating business from any other business of the CRA that may represent a conflict of interest to their rating services. On the other hand, there is a lack of clarity in this regard as CRAs do not have a precise and common definition of the concepts of ancillary and advisory services²⁵.

3.1.2.2. Conflict of interest and the dialogue of the analysts with the rated entity

CRAs have been criticised for being too involved in the structuring process of securitisation products. Both CESR and ESME express concerns in this respect in their reports²⁶. They point out that the dialogue between the CRAs and the issuers in the structuring process is often very close and happen on a continuous basis. This may raise concerns that the relationship between CRAs and the issuers of structured financial products is sometimes becoming too close and advisory in nature which could create conflicts of interests particularly given the fact that the profitability of a CRA is heavily dependent on the flow of its new structured finance ratings.

Moreover, CESR points out that there are cases where the analysts take part in the fee negotiation with the originator of the rated product. This is particularly the case in complex structured finance deals where rating staff may be involved in discussing the amount of work that has to be done as it also has an impact on fees.²⁷

3.1.3. "Shopping for ratings" practice

The practice of shopping for ratings takes place when issuers/arrangers of a structured product inquire several CRAs for their preliminary rating assessment of the potential structures before they finally decide on an issue. On the basis of the "best rating offer" received, the issuer/arranger will determine the choice of the rating agency that will prepare the official

²⁵ Paragraph 190 and 195 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

²⁶ Paragraph 180 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277); First paragraph of the answer to Question 12. ESME Report to the European Commission on the Role of Credit Rating Agencies. 4 June 2008.

²⁷ Paragraph 100 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

rating. This is likely to lead to ratings inflation and lack of applied methodological rigour. This practice is mentioned in IOSCO report and CESR has received evidence on this issue from stakeholders²⁸.

3.1.4. Analyst's independence when joining a rated entity

Rating analysts are an attractive recruitment target for investment banks and other originators/issuers. More recently, concerns have been raised that prior to their departure from the CRA they may be prone to look more favourably at issues originated by their future employer, and therefore such ratings would lack accuracy.

3.2. Lack of quality in methodology and ratings

As explained in Section 1.2 there was a significant number of downgrades in the second half of 2007 and first quarter of this year as compared to figures of the first half of 2007. These ratings failed to reflect market conditions in the underlying assets. One cause of this bad performance is most probably the lack of quality in the methodologies used by the CRAs to issue a rating²⁹. The main criticisms identified in this respect are the following:

- lack of a regular review of the methodologies and rating criteria;
- insufficient macroeconomic analysis in the ratings;
- inadequacy of the information on which the agencies base their rating opinion;
- lack of statistical checking;
- inadequacy of the staff involved in the rating of complex products.

3.2.1. Lack of adequacy of methodologies and rating criteria

The methodologies and models employed by the rating agencies appeared unable to properly reflect the worsening conditions in the underlying asset markets. Agencies were not keen to review their methodologies because they preferred as much stability of the ratings as possible. Among other sources, the FSF report indicated that the ratings performance may also have been damaged by flaws in the rating methodologies. These flaws in methodology include the impact of having only limited historical data in the area of subprime lending which led to the inability to assess how a pool of assets would respond to given economic scenarios. The FSF report points out that, in particular, the agencies underestimated the correlations in the defaults that could occur in the event of a wide market downturn. CESR considers that the delay in the downgrading process of structured finance securities backed by subprime mortgage assets raises questions on the efficiency of CRAs' methodologies, the robustness of their historical default models in a relatively new market and their rating surveillance

²⁸ Paragraphs 203 and 204 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

²⁹ Paragraph 106 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277). See annex 9.5.

procedures³⁰. It was recently published that technical errors in CRAs models could have also had a major distorting effect on the conclusions produced in the course of the rating process³¹.

3.2.2. *Lack of diligent monitoring of ratings; inconsistent application of changes to methodology; inadequate staffing.*

A critical part of the rating process is the surveillance or monitoring of the rating through the life of the product to which it refers. Surveillance should determine whether the agency should upgrade, downgrade or keep the rating unchanged. CRAs not only have issued a great number of ratings that assured investors of top credit quality of subprime products, but also they were not vigilant enough and did not downgrade such ratings in a timely way when the first signs of deterioration of the situation started to become apparent.

The difficulties experienced with structured finance ratings have demonstrated that CRA's were not attaching sufficient importance to monitoring the performance of the ratings issued in the past. Understaffing and low qualifications of the surveillance teams on the one hand and questionable frequency of the actual monitoring reviews of the ratings, and superficial character of such reviews on the other, have significantly affected the quality of ratings.

The lack of sufficient, high quality and skilled resources to deal with the rating of complex structured products has – in general – been considered as one of the possible explanations for the failures of the agencies. As mentioned above, this failure might have been even more severe in relation to the surveillance function.³² CESR has gathered evidence supporting this assumption during the consultation with stakeholders³³.

CRAs have also been found to be inconsistent in how they deal with ratings issued in the past, if the methodology or key assumptions they were based on have been altered. In particular, anecdotal evidence suggests that when an agency upgraded or downgraded rating of a specific issue as a result of a change in its methodology, the agency would not concurrently review or adjust the ratings given to similar products on the basis of such a methodology. Therefore, users often find it difficult to establish whether unchanged ratings have been maintained in the light of methodology change or whether they simply have not been reviewed.³⁴ Finally, recently concluded examinations by the US Securities and Exchange Commission revealed that some rating agencies were effectively using different methodologies and models for producing initial ratings and for ensuing surveillance activity.

³⁰ Paragraph 106 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

³¹ The Financial Times revealed in May that a computer bug distorted Moody's ratings for a complex instrument known as constant proportion debt obligation (CPDOs). However, Moody's maintained the top-notch ratings on these products until 2008, when they were downgraded amid general market declines. The agency never denied this event.

³² ESME echoes this concern: *"For structured finance, the resources of the CRAs have been stretched following the rapid growth in new ratings and the exponential growth in deteriorating structured finance securities. This has contributed to a delay in the re-rating decisions."*

³³ Paragraphs 159 and 160 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

³⁴ Paragraphs 136 and 137 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277) See annex 9.6.

3.2.3. Lack of quality in the information used by the CRAs

It is widely accepted that there is insufficient information available for market participants on the evolution of the underlying assets for specific structured products³⁵. In more mature market segments, the Prospectus³⁶ and Transparency³⁷ Directives require issuers to provide periodical and ongoing information to the public on the performance of the issuer and the financial instruments traded in a regulated market or offered to the public. Investors could not easily find similar information on the performance and evolution of the underlying assets of the structured products allowing them to perform their own risk assessment (e.g. the originator of RMBS is not obliged to disclose on a monthly or quarterly basis the performance of the underlying mortgages: number of foreclosures, failures, defaults, etc).

Another significant issue of concern is the information that the agencies use in order to make their decision on the ratings, for example, whether a significant level of fraud or irresponsibility has been identified with respect to the underlying assets of some structured products. This is mainly in relation to RMBS (loans given to creditors with very poor or false creditworthiness; exaggerated valuations of the underlying assets). Despite the fact that originators are obliged to carry out their own due diligence processes concerning the information that they are conveying to the agency, CRAs have not adequately checked the quality of the information they received from the originators³⁸.

The lack of disciplined underwriting allows for an increase in defaults through the use of inaccurate data or fraud. An analysis of a sample of loans which underperformed significantly compared with expectations based on each loan's disclosed risk attributes, showed a significant number of irregularities. Among other issues, 66 % of the mortgage files contained occupancy fraud, 51 % contained irregularities related to property value or other loan conditions, 44 % stated a questionable income or employment, 16 % indicated identity theft and 10 % indicated signature fraud. Less than 5000 cases of mortgage loan fraud were reported before 2002, while 2004 and 2005 showed 18,391 and 25,989 cases of fraud,

³⁵ The first of the four areas of action of the ECOFIN Roadmap of October 2007 relates to the transparency in the markets. The absence of accurate and timely information on exposures to credit risk has been a key factor in the generalised loss of investor confidence in financial markets since August 2007. Questions about the adequacy of transparency have been raised in several respects, including: (i) information provided to individual investors and the broader market by special purpose vehicles (SPVs), i.e. conduits and Structured Investment Vehicles (SIVs) involved in the securitisation process; (ii) bank disclosure of securitisation operations and exposures to SIVs, (iii) complexity in the structuring and measurement of risk in structured finance products as well as difficulties in valuating these products; and (iv) opacity in the functioning of markets for complex financial instruments. Supervisors, regulators and industry associations are examining how and where progress can be made in improving transparency, including in arrangements for information exchange among themselves.

³⁶ Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345, 31.12.2003, p. 64–89)

³⁷ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390, 31.12.2004, p. 38–57)

³⁸ Fitch Ratings has analysed this issue and concluded that poor underwriting practices and fraud may be widespread and account for as much as one-quarter of the underperformance of recently issued subprime RMBS. See: *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance*, Fitch Ratings, 28 November 2007 (research report available on website of Fitch).

respectively³⁹. Considering the real impact and the extent of poor underwriting standards and fraud in the class of subprime RMBS a thorough analysis of the actual quality of the loans seems warranted.

3.2.4. Lack of analytical information in the ratings on the impact of market developments and macro economic expectations and price volatility

It appears that the monitoring of the structured products ratings was very much limited to mere data monitoring, whereas the analysis of the impact on ratings of possible future macroeconomic expectations was left aside⁴⁰. Investors maintain that they were not able to ensure due diligence in their investment decisions based on ratings, as it was not clear how various market developments that move the parameters built-in the model may influence the rating change. Besides, currently the agencies do not include in their rating opinion any indication about the volatility of the ratings.

3.3. Lack of transparency of CRAs

CRAs do not communicate with sufficient precision the characteristics and limitation of the ratings of structured finance products and they do not provide either sufficient information on critical model assumptions. The lack of this information hinders the understanding of the ratings significance by market participants. CRAs do deliver information on rating performance, but such information does not facilitate comparison among CRAs' performance.

3.3.1. Structured and traditional ratings are not differentiated

CRAs use the same rating scale for structured and traditional ratings. Many investors, typically less familiar with securitisation products, were confused as to the risk profile of the instruments involved: as they drew simple comparisons with traditional debt, rated according to the same scales, they were convinced that AAA-rated securitisation products (e.g. CDOs) were as safe as sovereign debt. As for the rating agencies, most of them have been reluctant to consider separate rating scales for different asset classes. They argued that in quantitative terms the probabilities of defaults can be compared across diverse asset classes, although the instruments themselves have very different market characteristics. Nevertheless, more recently some agencies started seeking comments from market participants on the use of distinctive grades for different asset classes (see initiatives by Moody's and S&P's described in Annex 9.7). A survey from the CFA Institute⁴¹ dated on June 2008 posed the following question to its members (investment professionals): "*do you believe that CRAs ought to be compelled to use different rating symbols for structured products?*" There were 1.956 respondents, 47% answered yes, 42% answered no and 11% had no opinion.

3.3.2. No comparable information on CRAs performance available

CRAs occasionally furnish users of ratings with rating transition and default studies – analyses that track rating activity for debt instruments over a certain period. Such reports – done separately for structured finance and traditional debt – usually include a review of

³⁹ Fitch Rating also notes that such reports are only filed by federally chartered or federally insured institutions and the true number of cases could easily be two or three times higher. See: *The Impact of Poor Underwriting Practices...*

⁴⁰ ESME report, page 14 (see annex 9.6).

⁴¹ www.cfainstitute.org

upgrades/downgrades and defaults by rating category for each of the main sub sectors – e.g. for structured finance it could be ABS, RMBS, CMBS and CDOs⁴². As a result, these reports are potentially a good basis for assessing CRAs' sound judgment in attributing ratings over the years. There are two major caveats: firstly, market practitioners indicate that the data presented in these reports have not always been complete; secondly, rating agencies differ in their approaches to collecting relevant data and presenting them to the public.

4. OBJECTIVES

Accurate and independent ratings are essential for the proper functioning of the financial markets. Therefore the main objective of the Commission proposal is to ensure that ratings are reliable and accurate pieces of information. Consequently, it is of the utmost importance to mitigate any negative influence in the ratings that might result from conflicts of interest in CRAs, low standards of quality in the ratings and lack of transparency of the agencies. The objective of the European Commission is to achieve a solution for each of the elements of the three problematic areas that have been mentioned above under the problem definition section. Thus, the objectives of the proposal from the European Commission are the following:

- 1) Ensure that CRAs avoid and manage appropriately any conflict of interest.
- 2) Ensure that CRAs remain vigilant on the quality of the rating methodology and the ratings.
- 3) Increase the transparency of CRAs.

In addition there is an overall objective which is to enhance the compliance of CRAs with the measures responding to the three specific objectives listed above throughout the territory of the European Union.

4.1. Objectives in relation to CRAs' insufficiencies in their internal organisation and controls in relation to conflicts of interest

Conflicts of interest are inherent in any business. They relate not only to business relationships but also to other type of relationships, such as personal or economic relationships the staff and senior managers may have. Therefore, CRAs should be in a position to avoid conflicts of interest or, when they are unavoidable⁴³, manage them and mitigate their effects. This general objective can be specified in the following concrete objectives:

⁴² Please see Annex 9.3, where these acronyms are being explained.

⁴³ Following the example of other pieces of legislation there are situations where it is not possible to avoid all of the conflicts of interest. One example is Directive 2004/39/EC on markets in financial instruments (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1–44). Article 18 of this Directive provides investment firms are to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients; in case those arrangements are not sufficient to ensure that risks of damage to client interests will be prevented, the investment firm shall clearly disclose to the client the general nature and sources of conflicts.

- Ensure that the provision of advisory or ancillary services do not pose a conflict of interest to CRAs;
- ensure that the dialogue of the analysts with the rated entity remains unbiased and objective;
- arrange remuneration policies and structures in a way to eliminate or manage conflicts of interest;
- mitigate "shopping for ratings" practice;
- ensure the independence of the analysts when joining a rated entity.

4.2. Objectives in relation to the lack of quality of the methodology and the ratings

CRAs should improve the quality of the rating methodology and the ratings. The intention of the proposal from the European Commission in this regard should not be to prescribe a specific rating methodology, but to ensure the quality and due diligence of the CRAs in their activities. In particular, the following specific objectives should be fulfilled:

- Ensure that the methodologies, models and key rating assumptions are appropriate for the rated instruments;
- ensure that existing ratings are diligently monitored;
- ensure that changes in methodology are consistently applied to all ratings concerned;
- ensure that the information used by the CRAs to issue a specific rating is statistically sound;
- ensure that CRAs devote adequate staff (in terms of quantity and quality) to the rating process (initial rating and monitoring);
- ensure that the analysis of an issuer or a product takes into account the impact of market developments and macro economic expectations.

4.3. Objectives in relation to transparency of the CRAs

CRAs should improve transparency in relation to their internal policies and the presentation of the ratings. The purpose of enhanced transparency with regard to disclosures and record-keeping is two-fold: on the one hand, it will facilitate investor's awareness of the purpose and limitation of the ratings and it will allow comparison among CRAs performance. On the other hand, it will help to restore the confidence of the public on the rating business.

In particular, the following specific objectives should be fulfilled:

- Ensure sufficient transparency with respect to the functioning of internal processes and procedures;
- ensure that the information included in the ratings is relevant and sufficient in order to efficiently assess the probability of default of an instrument;

- avoid investors' confusion originated by the fact that the ratings for structured products and the ratings for traditional products (corporate, sovereign) are not distinguished;
- ensure that relevant data on CRAs performance in a standardised manner is available for market participants to allow for industry-wide comparisons.

4.4. Horizontal objective: Enhancing the CRAs' compliance with the measures responding to the three specific objectives

There should be a mechanism in place to ensure the effective compliance of the substantive requirements to be respected by CRAs. This mechanism should create the least possible burdens for CRAs while ensuring optimum observance of all substantive requirements.

5. IDENTIFICATION OF POLICY OPTIONS

The policy options that are going to be presented under this section have been developed in due consideration of the following sources: CESR Report, ESME Report, IOSCO Report on the Role of CRAs in Structured Finance Markets, the Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, the US Act on CRAs of 2006, the recent SEC regulatory proposals on CRAs and collective and individual initiatives presented by CRAs.

In the first section (5.1) we name the main policy options that have been discussed and proposed in relation to the substantive requirements that could be fulfilled by the CRAs in order to meet each of the objectives set out in section 4. The options presented under each of the objectives are not necessarily exclusive or substitutive among themselves. A more detailed description of each policy option that also indicates its source is found in annex 9.8.

In the next section (5.2) we shortly present the instruments that could be used to implement such requirements. The assessment of each of the different policy options – on material requirements and on instruments for implementation – is presented in sections 6.1 and 6.2 respectively.

5.1. Policy options on the substantive requirements

5.1.1. Policy options to remedy CRAs' insufficiencies in their internal organisation and controls in relation to conflicts of interest

The general policy in this regard is that CRAs have to ensure that existing and potential conflicts of interest will not affect ratings.

1. There should be some limitations for CRAs in order to avoid conflicts of interest.

Options:

- a) CRAs shall *identify conflicts* of interest and either eliminate or properly manage and disclose them.
- b) Impose *concrete limitations* on CRAs activities: CRAs shall not be entitled to issue a rating in certain situations that can impair their independence.

- c) Impose *high internal governance standards* including an independent review function and fit and proper requirements for non-executive directors.

2. To eliminate conflicts of interest in the provision of advisory services CRAs should avoid human or technical link between the rating and advisory activities.

Options:

- a) *Obligation to separate business:* A CRA shall separate, operationally and legally, its credit rating business and CRA analysts from any other businesses including consulting businesses.
- b) *Separation with additional caveats:* CRAs are required to publish a transparency report which discloses potential conflicts of interest.
- c) *Limited prohibition:* CRAs shall not provide consulting or advisory services to issuers that they are rating.
- d) *Complete prohibition:* CRAs shall not provide any consulting or advisory services.

3. CRAs should ensure that the dialogue of the analysts with the rated entity remains unbiased and objective.

Options:

- a) *Clearly defined role of the analysts:* Analysts shall be prohibited from making proposals or recommendations regarding the creation or design of structured finance products.
- b) *Transparency:* CRAs shall ensure that they are fully transparent in terms of the exact nature of their interaction with issuers/arrangers of structured finance products.
- c) *Record keeping:* CRAs shall record the event and substance of the dialogue between the analyst and the issuer.
- d) *Additional safeguards:* the analysts and any other employees directly involved in the credit rating process shall not be allowed to participate in discussions regarding fees or payments with any rated entity. The rating agencies should envisage compulsory periodic rotation of analysts.

4. CRAs should avoid the negative impact of conflicts of interest in relation to the remuneration prospects and other economic incentives of persons involved in the rating process.

Options:

- a) *Reporting lines* for the rating staff and their compensation arrangements shall be *structured* in a way to eliminate or effectively manage actual and potential conflicts of interest.
- b) *Additional organisational requirements:* the agency shall ensure the independence of the analysts and persons approving the ratings in the design of the reporting and

communication channels between them and the part of the agency responsible for the commercial interests of the entity;

- c) *Increase the fixed element of the salary for the top managers.*

5. The "shopping for ratings" practice should be mitigated.

Options:

- a) *Disclosure to the market:* an agency shall disclose on a periodic basis a list of all cases where it comes across a "shopping for rating" practice.
- b) *CRA's clients should refrain from shopping for ratings.*
- c) *Require issuers to disclose all necessary information* to allow all interested CRAs to provide unsolicited ratings.

6. The independence of the analysts should be granted even when he/she joins a rated entity.

Options:

- a) *Cooling off period:* During a certain period after leaving the agency the analyst shall not be able to accept key management positions from the previously rated entity.
- b) *Look back reviews:* The agency shall review the past work of an analyst in the event that he or she leaves the agency to work for a client that he or she has rated.

5.1.2. Policy options for improving the quality of rating methodologies and the ratings

1. Methodologies, models and key rating assumptions should be appropriate and up to date for the rated instruments.

Options:

- a) *CRAs shall put in place an independent rigorous and formal review function* responsible for periodically reviewing the methodologies and models it uses.
- b) *CRAs shall review its methodologies in case of significant changes* and on a regular basis, e.g. once a year.
- c) *Methodologies and models should be validated by a public authority.*

2. CRAs should diligently monitor the existing ratings.

Options:

- a) *Require CRAs to have separate teams* for the initial rating and the ongoing surveillance, both with adequate resources and expertise.
- b) *Require CRAs to regularly monitor and update ratings*
- c) *Envisage expiry of ratings after a certain time period*

3. CRAs should apply changes in methodology consistently to all ratings concerned.

Options:

- a) *Impose disclosure obligation:* CRAs shall disclose whether they apply retroactively model changes to existing ratings.
- b) *Re-rate regularly:* Require CRAs to apply the changes to past ratings due to the new methodology in the course of the regular review cycle of ratings
- c) Require CRAs to *promptly re-rate* existing ratings according to the new methodology.

4. CRAs should use sound information for the issuance of ratings.

Options:

- a) *Ensure good quality of information* in order to support a credible rating
- b) CRAs or a suitable third party (e.g. accounting firm) shall undertake due diligence of the underlying information:
- c) *Quality warranties:* CRAs shall require underwriters to provide representations about the level and scope of due diligence that they have performed and disclose the limits of their own due diligence.
- d) *CRAs shall abstain from issuing ratings if no sound data is available* or if the structure of the rated instrument is too complex to understand
- e) *CRAs shall warn the users of ratings if the underlying data is not sufficiently sound.*

5. CRAs shall allocate adequate staff to the rating process.

Options:

- a) CRAs shall ensure that employees directly involved in the rating process have appropriate knowledge and experience.
- b) *Additional transparency requirement with respect to the employees:* CRAs shall disclose staff numbers and qualifications as allocated to the different functions of the rating agency and keep record of the identity of credit analysts.
- c) *Require a formal qualification for rating analysts* defining a minimum level of knowledge and experience.

6. The analysis of an issuer or a product by the CRA should take into account the impact of market developments and macro economic expectations.

Options:

- a) *CRAs shall provide sufficient information about loss and cash-flow analysis related to the structured finance instrument.*

b) CRAs shall expand the initial and ongoing information that they provide on the risks characteristics of structured products and model assumptions by including additional information on e.g. the rating stability, the assumptions underlying a structured product rating, the sensitivity of the rating to changes in these assumptions, weightings of key parameters and correlations.

c) *Public authorities shall validate the models and assumptions applied by CRAs*

5.1.3. Policy options in relation to transparency of the CRAs

A number of options may be considered in order to trigger improvements in the CRAs' transparency as regards their internal policies, their performance and the presentation of the ratings. In particular, the following specific objectives should be fulfilled:

1. The agency has to be transparent with respect to the functioning of internal processes and procedures.

Options:

a) CRAs shall publish sufficient information about their procedures, methodologies, models and assumptions.

b) *Require CRAs to disclose a periodic report containing information such as legal structure and ownership of the CRA, description of the internal quality control system and indicators of staff allocation.*

2. The information included in the ratings has to be relevant and sufficient in order to efficiently assess the probability of default of an instrument.

Options:

a) Require CRAs to inform investors on loss and cash-flow analysis and about sensitiveness to changes in rating assumptions

b) Require CRAs to be committed to investors' education by clearly explaining attributes and limitations of credit rating opinions

c) Require additional technical information in the ratings: including, e.g. 'expected loss' 'worst case/best case scenarios ratings' and 'break-even' credit loss for different tranches as well as 'what if' scenarios.

3. Avoid investors' confusion triggered by the use of the same symbols for the ratings for structured products and the ratings for traditional debt (corporate, sovereign).

Options:

a) *Use different symbols or a different rating scale for traditional ratings and structured finance ratings.*

b) *Use the same scale but aggregate additional information to the ratings (highlighted by a label/rating suffix):* CRAs shall also inform users of the greater potential volatility associated with structured finance instruments.

- c) *Educate investors in the particularities of the ratings for structured products and traditional debt respectively*

4. CRAs should make available to market participants the relevant data about their performance in a standardised manner to allow for industry-wide comparisons.

Options:

- a) CRA industry shall establish a centralized repository for ratings performance studies to allow easier market comparisons among the CRAs and make available ratings performance data to regulatory authorities.
- b) *Obligation to publish historical default rates of CRA rating categories and whether the default rates of these categories have changed over time.*
- c) *Obligation to disclose standardised performance information and create a repository of ratings at EU level preferably by CESR.*

5.2. Instruments to put in place the policy option

In response to Objective 4.4 identified in Section 4 of this report (ensure that CRAs indeed comply with a given set of rules), several options may be considered, ranging from simple reliance on the CRAs' internal efforts to the establishment of a comprehensive surveillance framework administered by public authorities. It should be borne in mind that specific supervisory arrangements may imply prior use of a particular instrument introducing them as well as accompanying substantive requirements. For example, if a public authority were to be vested with the task of supervising CRAs, its competence would need to be anchored in binding legislation that would envisage clear obligations for the CRAs. Similarly, self-regulatory oversight mechanisms cannot be mandated by legislators or proclaimed by a single market player, but will normally require an industry wide commitment to succeed (e.g. expressed in a code of conduct).

Policy options chart

Supervision by public body				OPTION 4 Legislation at EU level
Oversight Body (private sector)	OPTION 2 European Code of Conduct			
No supervision	OPTION 1A IOSCO Code of Conduct	OPTION 1B Industry-wide efforts White Paper	OPTION 1C Additional initiatives by individual CRAs	OPTION 3 Commission Recommendation
	Self regulation			Rules at EU level

The above scheme identifies a number of policy approaches that could be considered to address the CRA issues. Each of them is effectively determined by two parameters: (i) how the CRAs are regulated [horizontal axis] (ii) how the CRAs are supervised [Vertical axis]. Those two parameters are closely interrelated. We may broadly distinguish the following approaches:

1. Proposing no action – existing solution remains satisfactory (self regulation based on IOSCO code and CRAs initiatives);
2. proposing a European code of conduct;
3. proposing a recommendation by the Commission;
4. proposing legislative measures;

As an essential element of these different policy alternatives, supervisory arrangements will be presented in the next subparagraphs. Each of these modalities for a supervisory framework is evaluated in section 6.

5.2.1. Self regulation (No policy change)

5.2.1.1. IOSCO code

This option implies that the European Commission would consider that the current situation in relation to CRAs is satisfactory and appropriate in order to fulfil the objectives described in section 4. In this case, the framework described in the Commission Communication in relation to CRAs in 2006⁴⁴ would be considered still adequate: CRAs should just adapt their internal codes of conduct to the revised IOSCO code⁴⁵. CESR would keep its monitoring role

⁴⁴ See section 1.4.

⁴⁵ In May 2008 the Members of IOSCO approved a revision of the code of conduct for CRAs. The relevant changes introduced in the code are mentioned in point 2.3.1 of this Impact Assessment.

and publish once a year an annual report to the European Commission on the compliance of CRAs with the IOSCO Code (for a more comprehensive explanation of the current framework in the EU, see annex 9.1). Additionally, this option would consider that the agencies themselves have come forward with appropriate solutions to the problems and concerns mentioned above. It should be noticed that CRAs have recently presented several initiatives, in the form of self-regulatory proposals (see 5.2.1.1 and 5.2.1.2). Initially the big CRAs put forward collectively a joint initiative. At a later stage, some of them presented additional initiatives on an individual basis.

5.2.1.2. Industry-wide efforts – White Paper

In January 2008 the five main CRAs⁴⁶ jointly addressed a White Paper to regulators with 12 proposals to improve the IOSCO code of conduct in relation to the independence, quality and transparency of the credit ratings:⁴⁷

- The independence of the credit rating process (prohibit analysts to make proposals or recommendations on the securitization products; advisory services should not be provided by CRA; "look back" reviews when analysts leave the agency should be imposed; periodical review of remuneration policies and practices for analysts should be in place).
- The quality of the ratings (introduce reviews of criteria and methodology of ratings; introduce improvements in the monitoring process; enhance staff training; encourage issuers for a full disclosure to the market of information on structured products).
- The transparency of credit ratings (set up of a centralised depository of ratings; give regulators access to data on rating performance to allow them to conduct their own controls on rating performance; investor education on the meaning of a rating, the rating process and CRAs' role in the market).

Almost all of the above mentioned proposals coincided with the reform plans of the IOSCO code⁴⁸.

5.2.1.3. Additional initiatives by individual CRAs

Apart from the joint proposal, each of the big CRAs put in place several improvements:

- On February 2008 Standards and Poor's presented an ambitious reform plan that included measures like the appointment of an Ombudsman for stakeholders, a public annual review of governance processes by an independent firm or the client rotation for analysts.
- In September 2007 Moody's proposed a set of practical requirements to enhance the control of the quality of the information about the underlying assets of a structured product. Later in March 2008 the agency presented other initiatives to better address the issue of the quality of the data used in the rating process. In February 2008 Moody's

⁴⁶ Standard & Poor's rating Services, Moody's Investors Services, Fitch, Inc., DBRS Limited and AM Best Company, Inc.

⁴⁷ A detailed summary of the proposals can be found in Annex 9.9.

⁴⁸ See point 2.3.1

carried out a public consultation on whether the rating scales for structured finance products should be differentiated from traditional ratings.

- Fitch has separated its non-rating businesses into a separate division (Fitch Solutions) and has implemented internal changes in its structured finance operations to support objectivity and consistency in the rating review process. Fitch presented further improvements, like increased analyst and manager rotation, enhancements to the formal internal training programs for analysts, greater external investor education efforts and is considering a broad range of feedback on other aspects of the current agency business model. The CRA also worked on the development of additional rating scales and indicators that would complement its opinions on structured finance transactions.

For a more detailed summary of these initiatives of the CRAs, see Annex 9.7.

5.2.2. *European Code of conduct for CRAs*

Another form of self-regulation but with some sort of external monitoring would be one inspired by CESR and ESME report: a code of conduct that encompasses IOSCO requirements (plus the recommendations made by CESR and ESME) and monitored by an external oversight body composed of e.g. representatives of investors, issuers and investment firms.

This self-regulatory solution could follow another precedent in the EU financial sector, the European Code of Conduct for Clearing and Settlement of November 2006. This is a voluntary solution and needs the previous common agreement of the CRA industry. The members of the industry would commit themselves in writing to respect a range of standards – listed in the code – and to accept and respect the recommendations of a monitoring body that would check the level of compliance of the code by the signatories. Nevertheless, this body would not be invested with enforcement powers.

This option is inspired by the CESR and ESME advice⁴⁹. Both bodies welcomed the revision of IOSCO code and made additional recommendations. Both bodies – explicitly or implicitly – recommended the Commission to promote a new voluntary European code of conduct (the revised IOSCO code supplemented by CESR/ESME recommendations). The role of the Commission in this case would be to invite those CRAs having relevant presence in the EU to adhere to such a code. ESME and CESR differed in relation to the oversight body that should monitor the compliance of CRAs with the standards of the code.

- a) CESR encouraged the Commission to form an international "*CRAs standard setting and monitoring body*"⁵⁰ that would develop international standards for the rating industry and would monitor the compliance of CRAs with those standards, using full transparency as the method for enforcement and having "name and shame" capacity. CESR also provided for a fall-back option in case this international oversight scheme

⁴⁹ See point 2.2.

⁵⁰ Paragraph 269 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

can not be achieved: In that case CESR recommends the formation of such a body at EU level.⁵¹

- b) ESME recommended that CESR should keep its monitoring role concerning the CRAs' adherence to the IOSCO code as set out in the Commission Communication on CRAs of 2006, but such a task should be bolstered by commissioning, in conjunction with the CRAs, an external annual review and report on the adequacy of corporate governance in each CRA and forming an advisory group to advise CESR of: (a) significant developments, trends and issues in the credit markets which are relevant to the activities of the CRAs; and (b) any rating trends/issues which are prompting concerns.⁵²

In this context, the Commission would have to invite CRAs to accept that such an international/European body is entitled to monitor their compliance with the code of conduct. To make it operative, CRAs should commit themselves to fully collaborate with the monitoring body.

5.2.3. Recommendation

Under this option the Commission would outline the standards that CRAs would have to comply with when they operate in the EU. These standards would be aligned with those mentioned in the fourth option (below). The standards would be built upon the revised IOSCO code and CESR and ESME recommendations, and would include those additional standards considered by the Commission relevant in order to achieve the objectives set out in section 4 of this Impact Assessment.

In accordance with Article 249 of the Treaty establishing the European Community, recommendations do not have binding force. It would therefore be up to the CRAs whether they comply with the standards set out in the Recommendation. This option of a voluntary nature would have similar effects to a code of conduct.

5.2.4. Legislation

A fourth policy option would consist in a legislative proposal to be presented by the Commission providing for a comprehensive regulatory framework for CRAs. The addressees of the rules would be all existing and prospective CRAs (with business operations in Europe) whose ratings are intended for use for regulatory purposes like the Capital Requirements Directive⁵³, by financial institutions in the EU.

The main objective of the legislative proposal would be to ensure that ratings are more reliable and accurate. Therefore it is of utmost importance to mitigate any negative influence on the ratings resulting from conflicts of interest within CRAs, low standards of quality in the ratings and lack of transparency of the agencies. The objective is to address systematically the

⁵¹ Paragraph 271 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277).

⁵² ESME's Report to the European Commission. Role of Credit Rating Agencies. June 2008.

⁵³ See section 1.4 and annex 9.1.

risks arising from these three areas. Thus, the objectives of the legislative proposal would be the following:

- Ensure that CRAs avoid and manage appropriately any conflict of interest.
- Ensure that CRAs apply a high standard for the quality of the rating methodology and the ratings.
- Increase the transparency of the CRAs.

On the one hand, the legislative proposal would contain a set of rules introducing a number of substantive requirements that CRAs will need to respect in the issuance of ratings. These substantive requirements would cover issues related to the organisational structure and internal governance of credit rating agencies, the avoidance and management of conflicts of interest, the quality of ratings and transparency obligations. These requirements would not interfere with the result of the rating process, (the content of the ratings) for which the CRAs retain full responsibility.

On the other hand, the legislative proposal will need to provide for a registration and surveillance system which is adapted to the specificities of the rating activity. There are two possible options regarding the supervisory architecture:

- In a first option public authorities in the Member States would be entrusted with the registration and surveillance of the rating activity. CESR would play a strong coordination role. Competent authorities would have legal powers to assess the compliance of the CRAs with the new legal requirements and would be entitled to impose sanctions on CRAs in case of non-compliance. In this framework the competent authority of the home Member State could decide on the registration request of an applicant CRA and would have the main responsibility in supervising this CRA and apply sanctions, where necessary. Other competent authorities would be strongly involved in the surveillance process and would retain competence notably in case of lack of or ineffective action by the competent authority of the home Member State. The convergence of supervisory and enforcement practices could be ensured by CESR
- A second option would be to set up a Community Agency (this could be either CESR or a new Agency) that would carry out the registration at central level. The daily surveillance of CRAs would remain with national regulators. The Agency would designate the home Member State competent authority for the surveillance and would coordinate the action of the competent authorities. It would also give advice to competent national authorities in supervisory issues. Further, the Agency would have the power to intervene in the event that national competent authorities fail to cooperate effectively. The mandate of the new Agency would be restricted to CRA issues. It would have its own staff and could also have technical committees. The Agency would be financed from the EU budget.

6. ANALYSIS OF IMPACTS

6.1. Analysis of the policy options on the substantive requirements

This section discusses the main issues to be addressed by each particular instrument among those described in section 5.2. Summary tables measure the comparative advantages and disadvantages of the different possible solutions against the following criteria:

- a) Effectiveness: The extent to which the option fulfils the objectives formulated in section 4.
- b) Certainty: There should be highest possible confidence of the relevant stakeholders as to the content of the rules to be respected and that the rules followed in practice are closely aligned with the objectives of the framework.
- c) Convergence: The framework for operation of CRAs should be governed by the same requirements in all Member States. A level playing field should be created. Furthermore, given the global dimension of this industry, it is necessary to take into account the global context, international standards and legal requirements in third countries (particularly US rules).
- d) Flexibility and efficiency: An environment should be established to facilitate the operation of CRAs across the Member States. CRAs should have a level of flexibility to shape their internal organisation, but without hampering the achievement of the objectives of the EU policy in this area. Flexibility, which captures simplicity, also is a cost indicator and therefore indicates efficiency: the greater the flexibility left to CRAs, the more CRAs can make choices adapted to their needs and control their costs.

In the tables, the options are measured against the above-mentioned pre-defined criteria. Each scenario is rated between “---” (very negative impact) and “+++” (very positive impact).

At the end of each assessment of the different policy options, it is highlighted which policy option(s) is/are best placed to reach the objectives outlined in section 4 with regard to the assessment criteria and are therefore the preferred policy options. The policy options do not necessarily exclude each other. Thus, the preferred policy response will often be a combination of the different policy options.

6.1.1. Analysis of the options to remedy CRAs' insufficiencies in their internal organisation and controls in relation to conflicts of interest

1. Limitations for CRAs in order to avoid conflicts of interest.

The existing general approach in the IOSCO Code has not been sufficiently effective to manage the CRAs' conflicts of interest. It does not guarantee certainty for stakeholders and CRAs. It essentially leaves to the CRAs to decide what is effectively prohibited and what safeguards are necessary in their internal structures and procedures.

The use of specific limitations, situations in which CRAs would not be allowed to issue credit ratings, would not be effective enough to manage all possible conflicts of interest in a CRA. Whilst for CRAs this solution would be easier than the introduction of changes in their internal structure, only the latter would offer strong structural underpinning to overcome the weaknesses of the current conflicts of interest management in the agencies and would ultimately help restore their credibility in the markets.

To impose certain limitations for CRAs in this field would be consistent with the US Act on CRAs, where CRAs have strict limitations for situations where there are links between the analysts or person approving ratings and the rated entity (a rating agency is not allowed to issue ratings when he or she has direct ownership or is a member of supervisory or

management board of the rated entity, or the CRA is associated with the rated entity) and where CRAs cannot receive more than the 10% of their annual revenue from the same client.

However, to impose a concrete limitation in the annual revenue that a CRA could receive from the same client could be disproportionate for small or newcomer CRAs. Therefore, an alternative solution could be not to impose such a limit but to require the agency to disclose to the public the cases where it has received more than the 5% of its annual revenue from the same client. The solution of disclosure when reaching certain limits would be consistent with the IOSCO code of conduct for CRAs.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Identification of conflicts	-	-	+	+
Concrete limitations	+	+	++	-
High internal governance standards	++	++	+	-

The preferred solution would thus be a combination of the three policy options proposed. Although a general principle may be offering too much flexibility on a standalone basis, it is important to keep it in order to cover any kind of conflict of interest which may emerge and which is not covered by express limitations. In addition appropriate internal governance requirements should also be part of the policy response.

2. Elimination of conflicts of interest in the provision of advisory services.

In order to ensure that CRAs are sufficiently insulated from the resulting conflicts of interest it is necessary to have an express prohibition of combining rating and advisory activity in the same rating agency. In few cases only would the disclosure be enough to manage these conflicts. On the whole, however, the range and magnitude of negative incentives to which a CRA would be exposed justifies that it is necessary to introduce a clear obligation to avoid all these conflicts, a prohibition of providing consulting or advisory services should be ensured. CRAs would need to revisit their business structure to ensure the complete elimination of consulting and advisory services from the product portfolio and strict focus on their core activity. The prohibition to provide advisory services is consistent with the US rules and IOSCO code provisions. In any event, most of the parent undertakings of the CRAs have already separated legally and operationally the consultancy part of the business from the rating activity. Therefore such requirement would not create any costs to the CRAs.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Obligation to separate business	+	+	-	+
Separation with additional caveats	+	+	+	+
Limited prohibition	+	++	+	-

Complete prohibition	++	++	++	-
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The preferred solution is a combination of the obligation to separate business and the complete prohibition of providing consulting or advisory services.

3. CRAs should ensure that the dialogue of the analysts with the rated entity remains unbiased and objective.

In line with IOSCO we consider that it is essential to increase the transparency of the rating process within CRAs. Thus, there is merit in monitoring analysts' activities and keeping records of any communication related to the credit rating activity. For some CRAs this may imply additional costs; however it will assist these CRAs which are already introducing some closer internal controls on the activity of analysts. Such measures would help to restore the credibility of CRAs' rating activity. Such an option would be consistent with the US requirements, where CRAs have extensive record keeping obligations.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Clearly defined role	-	-	-	+
Transparency	++	++	++	+
Record-keeping	++	++	++	+
Additional safeguards	++	++	++	+

As all these measures are complementary and safeguard the integrity and independence of analysts vis-à-vis the issuers, the preferred policy response would be a combination of all the options outlined above.

4. CRAs should avoid negative impact of conflict of interest in relation to the remuneration prospects and other economic incentives of persons involved in rating process.

Compensation policies are extremely important to ensure the objectivity of the credit rating process. It should be avoided that the analysts are compensated by reference to the amount of revenue that their work generates to the agency. It is necessary to ensure that the analysts are entirely independent from the commercial interests of the CRA (e.g. they are not involved in discussing impacts of methodology changes on CRAs' revenue prospects).

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Structure reporting lines	+	+	--	+
Additional organisational requirements	++	++	+	+
Increased fixed element of managers' salary	++	++	++	+

The preferred policy response would be inspired by the second and third policy option, i.e. in addition to structured reporting lines (status quo) compensation of rating analysts and managers should be de-linked from the amount of revenue generated by the analyst and other additional safeguards ensuring the independence of analysts from commercial interests of the CRA should be undertaken.

5. Elimination of the "shopping for ratings" practice.

The solution could consist in making the CRAs disclose information about cases of non-publication of credit ratings prepared and about cases where after a preliminary rating an originator of a structured finance instrument did not contract for a final rating. This measure would allow for closer market scrutiny of those engaging in the shopping for ratings and would take off some pressure from the CRAs to compete by way of offering more favourable ratings. By encouraging issuers to disclose all relevant information concerning structured finance products, CRAs would have the possibility to issue unsolicited ratings that might counter the rating opinion issued by another agency on the issuer's request; however, none of these measures would in itself eliminate the shopping for ratings. CRAs should not be entirely responsible for the elimination of such a practice; rather the clients of the CRAs should refrain from engaging in the "shopping for ratings".

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Disclosure to the market	+	+	++	-
Issuers to disclose information	+	-	-	+
Issuers should avoid the practice	++	-	+	++

The preferred policy option would be the third option mentioned above, i.e. to encourage issuers to avoid such a practice. This solution would be more effective and flexible, as it would not impose CRAs an obligation that is not up to them to meet.

6. The independence of the analysts should be granted even when he/she joins a rated entity.

A "cooling off" period⁵⁴ would effectively fulfil the objective of managing conflicts of interest. The "look back" review would reinforce the fulfilment of that objective.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Cooling off period	++	++	+	+
Look back reviews	++	++	++	++

The preferred policy response is a combination of a proportionate cooling off period together with look-back reviews.

6.1.2. Policy options for improving the quality of the methodology and the ratings

1. Methodologies, models and key rating assumptions should be appropriate and up to date for the rated instruments.

The need for an internal review function for the methodologies, models and key rating assumptions is now broadly accepted by CRAs. Moreover, it is largely accepted that CRAs should review their methodologies in case of significant developments to ensure the validity of their ratings; in addition, these reviews should also be undertaken on a periodic basis. The validation of the methodologies by the public authorities would not be effective enough given that public authorities may not always have the expertise and knowledge required to validate models for complex financial products. Such a solution would not be consistent with US rules or IOSCO code. Moreover, it would reduce the necessary flexibility that CRAs need to perform their activity and adapt to financial innovative products.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Review function	+	+	+	+
Review when significant changes	++	++	++	+
Validation of models by public authorities	-	+	-	-

Options 1 and 2 should be applied whereas option 3 (validation of methodologies by public authorities) does not appear to be proportionate.

2. CRAs should diligently monitor the existing ratings.

On-going monitoring of ratings by CRAs would be an effective measure to ensure the quality of the ratings. This would encourage timely adjustments of the ratings to the developments in

⁵⁴ See point 6 in section 5.1.1

the markets (as opposed to more cyclical reviews). This on-going monitoring of ratings is largely practised by the CRAs, and it may be further reinforced by some transparency obligations (e.g. disclosures on the scope and frequency of monitoring activity). While there may be some merit in introducing a periodic review to ensure more in-depth analysis of the validity of existing ratings, enough flexibility should be given to CRAs to perform this work. In the same vein, while it may be desirable to have separate teams in the CRAs for initial ratings and their subsequent reviews, it should not be translated – especially beyond the structured ratings field – into a firm requirement on CRAs.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Separate teams	++	++	+	-
Ongoing update of ratings	++	++	+	+
Expiry date for ratings	-	++	--	--

The preferred policy option is to require the ongoing update of ratings (Option 2).

3. CRAs should apply changes in methodology consistently to all ratings concerned.

In order to avoid confusion among users of ratings, changes in methodology should be applied not only to new ratings, but also to the existing ones. Whilst a regular review of ratings would allow CRAs to manage their workflow in a steady manner, prompt re-ratings according following changes to methodology would allow investors to refer to the more accurate creditworthiness assessments (i.e. more valuable for investment purposes). A simple obligation to disclose whether CRAs apply retroactively methodology changes to existing ratings would not appear sufficient.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Disclosure obligation	+	+	-	++
Re-rate regularly	+	+	+	+
Promptly re-rate	++	++	++	+

Option 3 requiring the CRAs to re-rate credit ratings promptly in case of a change of methodology is therefore the preferred policy option.

4. CRAs should use sound information to issue a specific rating.

Mere reliance on a general standard requiring CRAs to use data of sufficient quality may be insufficient. Measures imposing due diligence duties directly on CRAs (or suitable third parties working on their behalf) with regard to the information used in the ratings would likely lead to significant improvements in the quality of ratings, but at the same time create substantial additional burden for CRAs. A more proportionate solution would be an expectation that CRAs assess and factor in the rating process underwriters’ representations about the level and scope of due diligence that has been performed on the underlying assets.

In addition, high certainty would be brought to the markets, if CRAs abstained from issuing ratings when the data they have is not sufficiently sound. This late option would be consistent with US rules. More flexibility would be given to CRAs if an obligation of warning about the lack of sound information is imposed on them.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
General obligation to ensure quality of information	-	-	+	++
Due diligence requirement	++	++	++	--
Quality warranties	++	++	++	+
Abstain from issuing ratings without sound data	++	++	++	-
Warn if data not sufficiently sound	+	+	+	+

The preferred policy option would be a combination of all the options presented.

5. CRAs shall allocate adequate staff to the rating process.

CRAs will need to ensure that employees involved in the rating process are sufficiently qualified. CRAs should deliver on their commitments of increasing staff numbers and strengthening their expertise, as necessary. To this end, an obligation for CRAs to inform users of ratings on the rating and monitoring staff numbers – at least on a periodic basis – would seem appropriate to achieve the effect of increased market scrutiny and it would be consistent with US rules. Introducing a specific professional qualification for rating analysts would not appear particularly effective as a measure triggering higher quality of the rating staff.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
General obligation to employ appropriate staff	-	-	+	++
Transparency requirement	++	++	++	++
Formal Qualification for analysts	+	++	+	-

The preferred policy option is a combination of Options 1 and 2.

6. The analysis of an issuer or a product by the agency should take into account the impact of market developments and macro economic expectations.

Requiring additional information on risks characteristics, assumptions and stress testing would meet the expectations of investors and regulators and would help to restore confidence in the market. It would imply some additional efforts for CRAs. CRAs' assumptions and scenario analysis about economic and other systemic factors are an important part of the information that investors need if they are to use ratings properly. Investors should therefore have access to the assumptions and scenarios underlying the rating of structured finance products. On the other hand, although it could provide for a common framework of reference, the validation by public authorities of models and methodologies would be an extremely rigid solution. The shaping of the methodologies, models and assumptions that CRAs actually use should stay in the remit of the agencies themselves.

Option \ Criteria	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Additional information on loss and cash-flow analysis	+	+	+	-
Additional information on risk characteristics, model assumptions and stress testing	++	++	++	-
Validation by public authorities of models and assumptions	--	+	+	--

The preferred option would therefore be to have additional information on loss and cash-flow analysis and on risk characteristics model assumptions and stress testing (Options 1 and 2).

6.1.3. Analysis of the policy options in relation to transparency of the CRAs

1. Transparency of the agency with respect to the functioning of internal processes and procedures.

In principle, CRAs should take primary responsibility for setting the minimum standards of transparency with the markets in order to ensure greater market discipline. However, this approach bears the risk of being ineffective, if not subject to some exacting adjustments. In particular, a more formal disclosure in a periodic report (taking into account justified confidentiality concerns) would facilitate the monitoring of CRAs activities by the markets as well as comparisons of competing CRAs. Such an option would be consistent with US rules.

Option \ Criteria	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
General transparency obligation	+	+	+	++
Periodic report	++	++	+	-

The preferred policy options in this respect are to have a general principle on transparency in place (Option 1) coupled with the obligation to publish on a regular basis a transparency report. Given the benefits of a transparency report in terms of effectiveness and certainty the moderate limitations of the CRA's flexibility seem to be proportionate.

2. The information included in the ratings has to be relevant and sufficient in order to efficiently assess the probability of default of an instrument.

The disclosure of information relating to the credit rating is important to restore the confidence of the public on the credit ratings. It is broadly accepted that CRAs should provide sufficient information to allow investors to understand the basis for the credit ratings. However, it is also important to educate the investors so that they understand better the information released. More certainty would be introduced in the markets if CRAs would also share information on their key assumptions for the determination of the ratings.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
General obligation to inform investors	+	+	+	++
Investors' education	+	+	++	+
Additional technical information	++	++	+	+

All the three options are important and could be applied in parallel.

3. Avoid investors' confusion that has been created because of the use of the same symbols for the ratings for structured products and the ratings for traditional products (corporate, sovereign).

The problem of differentiating structured finance ratings from traditional ratings is among the most controversial issues in the current debate on CRAs. The use of different rating categories for structured finance ratings and the traditional products could enhance the market awareness of the specific risks implied by these instruments. A more flexible solution would be to provide additional information to the ratings for the structured finance products, although the result could be less comprehensible to market participants. A combination of these two later solutions would be consistent with US SEC recent proposal. The most flexible option would be to maintain the same scales and inform the investors about the particularities of specific ratings; however, this solution could not be sufficiently effective.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Differentiate symbols	++	++	++	-
Same scale but adding information	++	++	++	+
Educate investors	-	+	-	++

The preferred option is to leave at the choice of each CRA whether to have differentiated rating categories (symbols) for structured products and traditional products or the same scale with additional information.

4. CRAs should make available for market participants the relevant data about their performance in a standardised manner to allow for industry-wide comparisons.

CRAs should provide data about their performance; however, the data should be provided in such a way that it is understandable and suitable for comparisons by all interested parties. Thus, the most effective measure would be the disclosure of information in a standardised format and the creation of a repository of ratings. Such a solution would create the necessary certainty and level playing field as all the agencies would report according to the same standards; CRAs would thus be expected to adjust their existing reporting metrics. Such a solution would be consistent with US SEC proposal.

Criteria \ Option	Effectiveness	Certainty	Convergence	Flexibility/ Efficiency
Self-initiative	-	-	-	++
Obligation to publish individual data	-	-	-	+
Disclosure of standardised performance information	++	++	++	-

The preferred option is to require CRAs the disclosure of standardised information.

6.2. Analysis of instruments

To a certain degree, the same set of effects will be observed in each of the policy options identified, but their intensity may vary depending on the solution pursued. Analysis in this area will address only the most significant and distinctive impacts to assist the choice of the most adequate policy option. The four policy options identified in section 5.2 are discussed and measured against the following pre-defined criteria:

- a) Effectiveness: The extent to which the measure fulfils the objectives formulated in section 4.
- b) Certainty: There should be highest possible confidence of the relevant stakeholders as to the content of the rules to be respected and that the rules followed in practice are closely aligned with the objectives of the framework.
- c) Common framework: The framework for operation of CRAs should be governed by the same requirements in all Member States. Such approach represents a series of clear advantages. Firstly, it would be a necessary pre-condition for making CRAs subject to any form of external scrutiny (public supervision, accountability vis-à-vis the markets). Secondly, as all operating CRAs would respect certain entry conditions, it would create the necessary basis for the industry to rebuild its credibility after the subprime crisis. Furthermore, unnecessary obstacles to intra-Community activity of the agencies would be avoided (as a uniform set of rules would apply).
- d) Flexibility: A system should be established to facilitate the operation of CRAs across the Member States. CRAs should have a level of flexibility to shape their internal

organisation, but without hampering the achievement of objectives of the EU policy in this area. Flexibility, which captures simplicity, also is a cost indicator: the greater the flexibility left to CRAs, the more CRAs can make choices adapted to their needs and control their costs.

In the tables, the options are measured against the above-mentioned pre-defined criteria. Each scenario is rated between “---” (very negative impact) and “+++” (very positive impact).

6.2.1. Self-regulation (no policy change)

6.2.1.1. IOSCO code

In an effort to follow the reforms of the IOSCO Code, CRAs would voluntarily provide for ensuing changes in their internal organisation, processes and mechanisms. As the scope and depth of these necessary adjustments would be largely decided at the level of the individual entity, we would expect that the implementation and on-going compliance costs would be reasonable – from the point of view of the addressees of the rules. At the same time this option would demonstrate a number of serious weaknesses:

First, the IOSCO Code of Conduct would remain as the only set of rules governing the CRA industry in the EU. The manifest deficiencies of this non-binding charter as well as its influence on the actual conduct of the CRAs in the context of the subprime have been described in Section 3 of this Report. As a result of continuing the use of the IOSCO Code as the benchmark for CRAs' conduct the following problems would be observed:

- Compliance with the Code would not be a prerequisite for operating as a credit rating agency and competing for market share.
- The Code, based on 'comply or explain' principle, makes it possible for CRAs not to follow some of its requirements. There are examples, where some of the leading CRAs have decided to diverge from the duties mandated by Code⁵⁵.
- The rules to be followed by the CRAs are often formulated in a very broad or non-committing way leaving much room for interpretation and discretion to the CRAs.⁵⁶
- As there is no mechanism of external oversight of the CRA's actual compliance with the Code, CRAs would be only subject to internal oversight structures.
- As there is no mechanism of external enforcement and sanctioning CRAs would remain subject only to market discipline. Essentially, the latter could be triggered by negative developments that have damaged a CRA's reputation (e.g. consistently overoptimistic forecasts, incidents of collusion with the rated entities). However, given the oligopolistic structure of the CRAs' market, it is highly unlikely that market pressure alone is sufficient to discipline the CRAs to change their conduct.⁵⁷

⁵⁵ CESR report, paragraphs 211 to 225. See paragraph 225 in annex 9.6.

⁵⁶ For instance, under Point 1.7 of the revised IOSCO Code CRAs are required to "*adopt reasonable measures so that the information it uses in assigning a rating is of sufficient quality to support a credible rating*", but does not specify what those measures could be.

⁵⁷ At this stage there is no evidence of shifts of clients from one agency to other or from the big CRAs to new agencies.

Assessment

The continued reliance on the IOSCO Code does not give sufficient assurance that the objectives formulated in Section 4 of this report will be effectively achieved. The management of conflicts of interest by CRA would remain inappropriate; CRAs would not be obliged to improve the quality of the rating methodology and the ratings; the transparency of the CRAs would remain insufficient; and, there would be no supervision and enforcement mechanism by competent authorities. Therefore the existing framework does not ensure certainty and is not sufficiently effective. Nor does it ensure the level of common framework which would enable CRAs to rebuild their credibility and restore the confidence in the markets. However, it ensures flexibility to CRAs for the organisation and operation of their business, although the current environment, mainly based on reputation considerations makes it very difficult for new CRAs to enter the business.

It is crucial to ascertain that any framework proposed for the activity of the CRAs will be duly implemented, diligently supervised and robustly enforced. These premises cannot be met if the IOSCO Code continues to be the central element of the regulatory policy approach to CRAs' activity in Europe. Self regulation has been tested since 2006 and the outcome is not acceptable.

6.2.1.2. Industry-wide efforts – White Paper

The Industry White Paper envisaged a series of quite significant and helpful commitments. The advantages of this solution are that it comes from the industry (see Annex 9.9). However the White Paper does not give a satisfactory answer to all concerns related to the conflicts of interest; it does not propose differentiation of structured finance ratings from traditional ratings; it does not mention the need for comparability of CRA performance statistics; it does not solve the problems related to the poor quality in the information used by the CRAs, as it does not envisage any relevant measures applicable to the reliance on external data for rating purposes; and it does not provide for a satisfactory solution in relation to the proper treatment of existing ratings. In addition, the main weakness of this option is that it does not envisage any oversight and enforcement mechanism. It is important to notice that in practical terms the majority of the proposals from the White Paper have been included in the IOSCO code after its revision. Therefore there is no added value in this policy option. The criticisms mentioned in the previous point dealing with the assessment of the "no policy change" scenario are also valid for this solution.

Assessment

Such a solution would present a high level of flexibility for CRAs because they would be free to adapt to the new voluntary requirements. However, it would not be effective since it does not envisage any enforcement mechanism. Despite the fact of being a joint initiative by industry, it would ensure a common framework only at the level of the commitments put forward in the Joint White Paper. Thus, no certainty would be ensured by this solution. The same arguments expressed in the precedent point would be valid.

6.2.1.3. Individual self-regulatory solutions proposed by CRAs:

All the individual initiatives from the CRAs referred in point 5.2.2 represent the advantage that they are driven by commitments coming from the industry. However, these initiatives cannot be considered as a satisfactory solution as the proposals by CRAs do not address in a

consistent way each of the substantial problems that have been identified in this Impact Assessment.

Moreover, CRAs have failed to propose any credible system of oversight and enforcement of their initiatives. Proposals by the agencies concerning the fact that they would internalise the oversight function are not sufficient and would not guarantee rigorous scrutiny about whether CRAs actually observe the requirements imposed on them. To strengthen the oversight framework, there should be sanctioning powers in case of non-compliance.

Assessment

This option, in spite of being very flexible (each CRA would implement individually its own improvements), would not ensure a common framework. Limited effectiveness would be achieved, only concerning the issues where the CRA has committed, although no certainty would be ensured. The same arguments expressed in the point dealing with the "no policy change" scenario would be valid.

6.2.2. *European code of conduct*

The cost of implementation of the code of conduct for the CRAs would be comparable to the costs of the other self-regulatory options: it would arise essentially in connection with compliance duties and would depend on the concrete requirements of the code. However, this solution has the following limitations:

- The adherence to the code is voluntary. Therefore a CRA could step out of the agreement at any moment or challenge the authority of the oversight body.
- The monitoring body for CRAs would not be capable of ensuring vigorous supervision and enforcement. Such a body would not be entitled to carry out investigations with the requirements and guarantees of a procedure carried out by a public authority and should only rely on the information provided by the agencies. Furthermore, the effectiveness of the enforcement power of this body will be limited: in case an agency breaches any of the standards of the code, the body would only be empowered to issue a statement warning about this situation, but it would not be empowered to impose the cessation of such practice or a sanction.

The recent events have unveiled that the reputational risk is not sufficient for CRAs to abandon harmful practices. A model of supervision where CRAs decide what should be the information that the oversight body will receive and where *naming and shaming* is the most severe penalty for their lack of compliance is not efficient.

Assessment

Such a solution has the advantage of including a monitoring body, although without any enforcement power, so its effectiveness would be limited. It would ensure certain common framework, although no significant certainty could be achieved. High flexibility would be ensured by this solution, because CRAs would draft the code.

6.2.3. *Recommendation*

In this case the Commission would be in a position to drive the process and to align the standards with the objectives that have been defined in Section 4 of this Impact Assessment.

However, this solution has the same limitations that were pointed out in relation to the self-regulatory option. A recommendation is not legally binding on CRAs; the agencies could choose not to follow it. It cannot set up a system of supervision and enforcement either.

Assessment

Such a solution would help establish a common framework to some extent, at least concerning the reference criteria that CRAs would have to fulfil; however, it would not include an enforcement mechanism and thus it would have limited effectiveness in achieving the objectives set out in Section 4. It would allow for flexibility to CRAs, although no certainty would be achieved because CRAs would not be obliged to comply with the Recommendation.

6.2.4. Legislative proposal

A legislative proposal would create a framework for supervisors to ensure the consistent application of the new set of requirements for the issuance of credit ratings to be used by financial institutions in the EU. CRAs would face sanctions by public authorities in the case of breach of the legal requirements (just as banks, investment firms, insurance companies or UCITS currently do in the EU). The compliance of the CRAs would not be at the discretion of the CRAs nor would it be subject to interpretation by interested parties.

The same rules would be applied throughout the Community. The legislative proposal would create legal certainty and transparency. The registration and surveillance system would be known by all market players concerned which thus could have greater confidence that the CRAs whose ratings are used for regulatory purposes conform to established regulatory standards.

A legislative proposal could be indirectly beneficial for competition for the small CRAs. Smaller entities meeting the requirements laid down in the legislation would be registered and be able to issue credit ratings under the same conditions as big CRAs already established in the EU. If they comply with the registration requirements, the registration will act as public recognition of their rating capability for the whole market, thus facilitating newcomers to overcome the barrier to entry of the oligopolistic rating business. The maintenance of the current situation would only preserve the existing oligopolistic market structure.

Uniformity in the registration process and in the substantive requirements throughout the EU would also allow CRAs to make significant cost savings, both in the case of the creation of a new CRA and in the operation of existing CRAs, if compared to the establishment of individual national registration regimes (cost savings on the expert legal advice on individual national regimes).

As explained in section 5.2.4, there are two possible options regarding the supervisory architecture: the first option is that the Member States would be entrusted with the registration and surveillance of the rating activity performed by CRAs and CESR would play a strong coordination role. The second option is to set up a Community Agency (this could be either a new Agency or transforming CESR into one) for the registration of CRAs at central level (but supervision would remain with national regulators).

The first option appears to be more practical because the securities markets supervisory authorities of the Member States already have the knowledge, expertise and resources to oversee different entities and activities in the EU securities markets (like, for example, regulated securities markets, investment firms or UCITS managers). The option of the

Community Agency has gathered little support taking into account the input from the public consultation. In addition, the European Commission has committed itself to carry out an evaluation of the functioning of the existing Community Agencies before it will envisage creation of a new one (Communication COM(2008)135 of 11.3.2008 "European agencies – The way forward").

CRAs could face higher compliance costs derived from the registration regime and the on-going surveillance by competent authorities. Requirements necessary to verify compliance with the legal provisions, such as reporting requirements, record keeping and transparency obligations could add new administrative costs to the operation of the CRAs. However, these additional costs would be mitigated by the fact that CRAs already comply with similar requirements in other jurisdictions (like the US) and some of them have already started a process of improving their internal procedures and transparency in order to respond to current criticisms.

All CRAs established in the EU issuing credit ratings intended for use for regulatory purposes by financial institutions in the EU will have to apply for the registration. This is essential in order to ensure a high level of investor confidence and consumer protection. As the rules in the legislative proposal would be to a considerable extent based on IOSCO rules and convergent with US requirements, the adaptation costs for the established CRAs should not be too high, as CRAs are already subject to registration and supervision in the US.

A legislative proposal could create the impression that supervisors endorse the ratings given by the CRAs. To avoid such an unintended consequence, it is essential that the independence of a CRA in issuing its credit ratings is preserved. Rating opinions and rating methodologies should not be subject to supervisory scrutiny or any form of regulatory influence. In addition, under no circumstances will a competent authority of a Member State be able to take measures against a CRA based on the fact that the CRA issues rating opinions that may be contrary to the interests of the Member State or specific issuers.

A legislative measure is by definition less flexible than a self-regulatory solution. This lack of flexibility could make it more difficult in the future to adapt the standards to market innovation or new situations. However, the use of the Lamfalussy process could allow for a more flexible regulatory regime, by the elaboration of implementing measures through comitology (Level 2). Moreover, the legislative proposal should be principles based and, to the extent possible, avoid unnecessary technical details.

Assessment

Such a solution would largely ensure a common framework for the issuance of ratings and legal certainty throughout the Community. The system would be flexible enough to allow CRAs to be innovative in the way they produce their ratings. Such a solution, including a diligent supervisory system and robust enforcement mechanism, would ensure a high level of effectiveness in assuring compliance with the objectives formulated in Section 4. Finally, a legislative solution would be convergent with the US, where CRAs are regulated entities subject to registration and supervision by the US Securities and Exchange Commission.

6.3. Conclusion

Self regulation has already been tested and has failed to guarantee the fulfilment of the objectives set out in section 4. A recommendation would not achieve the necessary level of uniformity and legal certainty and therefore would not be sufficiently effective. A legislative

solution would be a proportionate measure to fulfil the objectives of providing for a uniform CRA regime across the EU. It would be based on consistently applied high-level principles and largely inspired by the IOSCO Code. Thus, there would be only limited additional costs for CRA, in particular as they are already adapting themselves to the revised IOSCO Code requirements. Furthermore, the legislative solution would not impose on Member States any requirement to modify their existing laws, as nowadays there are very few requirements at national level, but merely to introduce the new CRA registration and surveillance regime.

Scenario	Effectiveness	Certainty	Common framework	Flexibility/ Efficiency
Criteria				
Self-regulation:				
IOSCO	-	--	+	++
White Paper	-	--	+	++
Individual solutions (No policy change)	-	--	--	++
EU code of conduct	-	+	+	+
Recommendation	-	-	+	+
Legislative measure	++	++	++	+

In order to meet objective 4.1 (insufficiencies in the internal organisation of CRAs and controls in relation to conflicts of interest), CRAs will have to ensure that all existing and potential conflicts of interests are identified and either eliminated or properly managed and disclosed. Specific internal governance arrangements will need to be put in place to assist changes to corporate culture and internal policies. CRAs shall be prohibited from providing consultancy and advisory services. Rating analysts will need to be insulated from the commercial aspects of the CRAs' activities and they will need to be subject to more demanding rules regarding dialogue with the client. When they decide to leave to work for a former client, specific safeguard rules should apply. Finally, CRAs clients should eliminate the negative 'shopping for ratings' practice.

In order to meet objective 4.2 (improve quality of the methodology and the ratings), CRAs will need to use methodologies that are rigorous, systematic, continuous, and may be validated based on historical experience. These methodologies, models and key ratings assumptions will need to be kept up-to-date and subject to comprehensive regular review. An internal review function will be established to monitor compliance in this area. Changes to rating methodologies shall trigger prompt re-rating of all existing ratings concerned. Moreover, CRAs will have to monitor and update individual ratings on an ongoing basis. Greater transparency will be required to assist users of ratings in understanding what due diligence of the asset level data has been undertaken and factored in the ratings. Staff levels will need to be disclosed by CRAs to trigger closer market scrutiny.

Enhanced transparency of the CRAs' activities is needed in line with objective 4.3 (improve the transparency of CRAs). Relevant measures will have to include a general transparency obligation regarding the functioning of the CRA's internal processes and procedures coupled with a duty to publish a yearly transparency report. The information on analyses performed,

any limitations and specific risks involved will need to be provided to the users of ratings. CRAs should also use different rating categories for structured and traditional debt or provide investors with additional information when rating structured finance product. Finally, historical performance statistics will need to be prepared using metrics that ensure comparability between market players.

The legislation will set up a registration procedure for CRAs issuing credit ratings to be used by credit institutions, investment firms, insurance and assurance undertakings, collective investment schemes, pension funds and reinsurance undertakings within the Community. The objective of efficient and effective monitoring of compliance with the requirements (overarching objective 4.4) will be ensured throughout the EU. The registration will be carried out by the competent authority of a Member State, but all Member States' regulators should be able to express their opinion through the CESR. Surveillance will be carried out by the competent authorities of the Member States. Close cooperation between national regulators and coordination by CESR is a prerequisite for creating a common supervisory culture and an efficient network. National regulators should be empowered to apply proportionate and dissuasive sanctions where CRAs do not comply with the rules. Again, CESR should play an important role in creating a common enforcement culture. Therefore a legislative measure would be the appropriate instrument to achieve the objectives set out in Section 4.

7. ANALYSIS OF IMPACTS OF THE PREFERRED OPTION

7.1. Impacts on stakeholders

The following table compares the impact of a legislative measure comprising the preferred policy options (see section 6) with the impact of a do nothing scenario (self regulation).

Scenario	Impact on Stakeholders			
	CRAs	Issuers/ Originators	Investors	Supervisors
No policy change (self regulation)	-	--	--	0
	CRAs find it difficult to prove that changes resulting from revised IOSCO code and their proposals effectively address all concerns identified. Continued lack of trust in their structured rating activity.	Issuers continue to suffer from the lack of trust in ratings of their financial instruments. New issues limited as perception of 'flawed rating risks' still high in structured markets.	Still affected by CRAs' unpredictable treatment of structured ratings. Increasingly reluctant to rely on CRAs' opinions in future investment decisions.	Situation unchanged
Legislative measure comprising preferred policy options	+	++	+++	+
	Though CRAs would have to face higher adaptation costs, more interest in ratings from the investors will increase CRA profits in the long term. Long term benefits of legislation may outweigh higher administrative/adaptation costs	Issuers indirectly profit from greater investor interest and confidence and more competition within the rating market.	Investors will directly profit from increase in quality of ratings and transparency. This will contribute to better investment decisions and increasing investor confidence.	Supervisors able to monitor the CRAs conduct. Power to enforce legislation.

In the tables, each scenario is rated between “---” (very negative impact) and “+++” (very positive impact), being "0" neutral impact.

It is not expected that the legislative proposal is going to have any direct impact on the natural environment, or on the social, employment or gender policy of the EU.

7.2. Estimation of administrative costs

The following requirements of the legislative proposal will create administrative costs for the CRAs, especially the compliance costs:

- Transparency obligations: annual transparency report, performance statistics;
- Disclosure requirements: on going disclosures on conflicts of interest, methodologies, internal procedures, changes in the initial conditions of the registration;
- Enhanced standards for presentation of ratings;
- Record keeping requirements: recording devices or systems and data archiving system.

It is not envisaged that CRAs will have to face any cost or losses from the prohibition to provide advisory services. In general, the holdings owning the big CRAs already have legally and operationally separated their rating business from the consulting activities.

The administrative requirements of the legislative proposal are very much aligned with the requirements set up in the US Act on CRAs of 2006 and the new changes proposed by the SEC (see Annex 9.5). On a global scale there will be few additional administrative burdens for the CRAs that are active in both the European Union and the US.

Since the administrative obligations are comparable with those in the US, they are also comparable in terms of administrative cost. The estimation below of the administrative costs for CRAs is based on the studies carried out by the US Securities and Exchange Commission in this regard.⁵⁸

The cost of compliance with these requirements would depend on its size and the complexity of the business activities of a CRA. The size and complexity of CRAs vary significantly. Therefore, the cost could vary significantly across agencies. The main CRAs already have established policies, procedures and record keeping systems and processes in the US that would comply substantially with the requirements of the legislative proposal, and they could easily translate the know-how and expertise from the US and apply them to their organisation in the EU. The cost estimates below represent the average cost across all CRAs and do not take into account that some firms would only need to adjust existing policies, procedures and recordkeeping systems and processes to comply with the requirements of the legislative proposal.

It is expected that the employers executing the work with the CRAs are highly skilled professional staff that would roughly earn the same in all European countries.

The wage figures used below are taken from the preliminary data of the measurement of the administrative costs in the Programme for Reducing Administrative Burdens in the EU.

One time administrative burdens

Obligation	Wage p/h	Hours	Frequency	Number of companies	Admin cost	Overhead 25%	TOTAL admin costs
Adjusting disclosure systems, policies and procedures	49.11	300	NA	15	220.995	55.248,75	276.243,75
Record keeping device	One time costs of 2.000 Euro		NA	15	30.000	7.500	37.500

Combined one time administrative burdens: 313.743,57 Euro.

⁵⁸ 17 CFR Parts 240 and 249b [Release No. 34-57967; File No. S7-13-08] RIN 3235-AK14 Proposed Rules for Nationally Recognized Statistical Rating Organizations, pages 124 to 148.

Reoccurring administrative burdens

Obligation	Wage p/h	Hours	Frequency	Number of companies	Admin cost	Overhead 25%	TOTAL admin costs
Additional transparency obligations for the annual report and performance statistics	49.11	20	1	15	14.733	3.683,25	18.416,25

Combined reoccurring administrative burdens: 18.416,75 Euro per year.

As set out in point 5.2.4, there were two possible options regarding the supervisory architecture. The first option would be built upon registration and surveillance by competent authorities of the Member States with coordination by CESR. Therefore its implementation would not create substantial costs at EU level. The second option was to set up a Community Agency that would issue the registration for CRAs and coordinate the national supervisors. This would involve additional costs which cannot be estimated at this stage.

8. MONITORING AND EVALUATION

The Commission is the guardian of the Treaty and therefore will monitor how Member States have implemented the legislation on CRAs. Where needed, the Commission services will offer assistance to Member States for the implementation of the legislative proposal in the form of transposition workshops with all the Member States or bilateral meetings at the request of any of them. When necessary and as the last resort, the Commission will pursue the procedure set out in Article 226 of the Treaty in case any Member State fails to respect its duties concerning the implementation of Community Law.

The evaluation of the consequences of the application of the legislative measure could take place three years after the entry into force of the legislative measure in the form of a Commission report to the Council and the European Parliament.⁵⁹ This report should cover the issue of over-reliance on ratings by investors. However, CESR could keep producing the annual report on CRAs. In this case, the report should not be focused on the implementation of the IOSCO code by the CRAs, but on the application of the new legislation.

The main elements that could be used during the evaluation could be the evolution of the ratings statistics per product, the trends in the issuance of structured finance products, the number of CRAs asking for registration in the EU (in particular whether there have been new comers into the rating business), the statistics on ratings volatility (with particular emphasis in sharp downgrades), the comparison of data on CRAs performance and enforcement record of the EU national authorities supervising the CRAs.

⁵⁹ There are precedents in financial services legislation of such reviews. In accordance with Article 31 of the Prospectus Directive 2003/71/EC and Article 33 of the Transparency Directive 2004/109/EC, after five years of the entry into force of these Directives the Commission is expected to assess its application.

9. ANNEXES

9.1. The legal framework for CRAs

The current legal framework for CRAs is very different in the EU and in the US. While in the US CRAs are subject to legislation, there are not directly binding rules governing CRAs activities as such in the EU. CRAs are affected only indirectly by sectoral regulation (Market Abuse and Capital Requirements Directives).

1. The regulatory framework in EU: IOSCO code, Market Abuse Directive and Capital Requirements Directive

In its Communication of 2006, setting out the regulatory approach to CRAs⁶⁰, the Commission invited the CRAs to subscribe voluntarily to the code of conduct for CRAs that was approved by the International Organisation of Securities Commissions (IOSCO) in 2004. However, the Commission stated clearly that it would monitor the developments in this area very carefully. At present, Community law addresses only specific aspects relevant to the activity of the rating business, basically measures included in the Market Abuse Directive⁶¹ and the Capital Requirements Directive⁶².

1.1. IOSCO code of Fundamentals for CRAs and CESR's role

Since 2003 there has been a task force in IOSCO studying issues related to the activities of CRAs. In September 2003 the task force issued a report describing the role CRAs play in the global capital market together with a set of principles on integrity of the rating process and high quality of ratings. This set of principles – addressed to supervisors, CRAs and other market participants – was converted later into a code of conduct for CRAs in December 2004. The IOSCO CRA Principles are high-level and meant to be used by CRAs of all types and sizes, using all types of methodologies, and operating under a wide variety of legal and market environments. IOSCO code is composed by more than fifty provisions aimed to avoid properly CRAs' conflicts of interest, ensure the consistent use of their rating methodologies, provide investors with sufficient information on the quality of a CRA's ratings, and help to ensure the integrity of the overall process.

Against the background of various financial scandals in the US and the EU and following the resolution on CRAs adopted by the European Parliament in February 2004, the Commission considered very carefully whether or not fresh legislative proposals were required to regulate the activities of CRAs. One of the central principles of "Better Regulation" is that legislative solutions should be applied only where there is a market failure and where legislation is strictly necessary to address that market failure and to achieve public policy objectives. In line with the advice received from the CESR in March 2005, the Commission decided not to present new legislative proposals in the area of CRAs considering that the existing financial

⁶⁰ Communication from the Commission on Credit Rating Agencies (OJ C 59/2, 11.3.2006)

⁶¹ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation OJ L 96, 12.4.2003, p. 16

⁶² Article 80 *et seq* of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions OJ L 177, 30.6.2006, p. 33

services directives applicable to CRAs would provide an answer to all the major issues of concern raised by the European Parliament.

As a consequence, in 2006 the Commission issued the Communication on Credit Rating Agencies, in which the Commission concluded that various financial services directives, combined with self regulation by the CRAs themselves on the basis of the IOSCO Code of Conduct Fundamentals for CRAs (IOSCO Code), could provide an answer to the major issues of concern in relation to CRAs. It was stated that this approach would require continuous monitoring of developments in this area by the Commission. In addition, the Commission asked CESR to monitor compliance with the IOSCO Code and report back on an annual basis.

It was concluded that CRAs had to incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct. Where they choose not to do so, they had to explain how their Code nevertheless gives effect to the provisions of the IOSCO Code. It was considered imperative that CRAs not only incorporate the IOSCO Code in their own Code of Conduct but fully comply with the IOSCO Code by enforcing their Code of Conduct in daily practice. Therefore, it was concluded that CESR's annual report should provide a thorough assessment of the level of day to day application of the IOSCO Code in practice, including consultation of all stakeholders.

The Commission asked CESR to specifically address in its report the following issues of concern: transparency of ratings disclosure as regards the level of participation of the issuer in the ratings process; timeliness of ratings disclosure as regards prior notification of issuer of an imminent rating; the procedures for fee arrangements, specifically the involvement of analysts in the fee negotiations with the issuer; separation of CRAs' business activities and handling of conflicts of interest; quality of the ratings process as regards structured finance instruments, i.e. are sufficient resources devoted to make proper rating assessments of these complex instruments and to monitor on an ongoing basis the developments in the area of structured finance; treatment of confidential information within the various departments of CRAs; disclosure of income structures; position of compliance officer. A more detailed explanation of CESR monitoring role can be found later in this IA.

The Commission indicated in the Communication that it might consider introducing new proposals if it became clear that compliance with EU rules or IOSCO's code was unsatisfactory or if new circumstances were to arise – including serious problems of market failure or fresh developments in other parts of the world.

IOSCO code has been recently revised in depth, as it is described further in this document.

1.2. CRAs in Market Abuse Directive

In accordance with article 6.5 of the Market Abuse Directive (2003/6/EC) the *"persons who produce or disseminate research concerning financial instruments or issuers of financial instruments and persons who produce or disseminate other information recommending or suggesting investment strategy, intended for distribution channels or for the public, (should) take reasonable care to ensure that such information is fairly presented and disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates"*. The technical arrangements for the fair presentation of research and other information recommending investment strategy are developed in the Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the

European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest.

According to recital 10 of the Directive, *"Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument as of a given date. As such, these opinions do not constitute a recommendation within the meaning of this Directive"*. As a consequence the ratings issued by the CRAs are not subject to the legal framework set out in this Directive. However, in accordance with the quoted recital, CRAs *"should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they appropriately disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate."*

1.3. CRAs in Capital Requirements Directive

Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (Capital Requirements Directive, CRD) provides for the use of external credit assessments in the determination of risk weights (and consequential capital requirements) applied to a bank or investment firm's exposures. Only the use of assessments provided by recognised External Credit Assessment Institutions ('ECAIs'), mainly CRAs, will be acceptable to the competent authorities. A recognition mechanism is also outlined in the Directive.

The CRD sets out a number of requirements which ECAIs should meet before the competent authority grant them recognition. Article 81.2 of Directive 2006/48/EC states that the *"competent authorities shall recognise an ECAI as eligible (...) only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency."* These technical criteria and requirements are listed in the Annex VI, Part 2 of the Directive. The competent authorities should assess whether individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments and accessible at equivalent terms to all interested parties. Building on the CRD, the Committee of European Banking Supervisors ('CEBS') has been working to promote convergence of the recognition processes of ECAIs across the EU by defining a common understanding on the criteria necessary to implement the recognition requirements laid down in the CRD. In January 2006 CEBS published the Guidelines on the recognition of ECAIs.

To date, the majority of the EU banking supervisors have recognised as ECAIs the four big CRAs (Standard and Poor's, Fitch, Moody's and DBRS).

2. The legal framework in the US

The US Credit Rating Agency Reform Act of 2006 entered into force on 27 June 2007. This Act establishes a legal framework for a voluntary registration and qualification process for NRSRO (Nationally Recognized Statistical Rating Organization).

The Act establishes a framework for a revised NRSRO (Nationally Recognized Statistical Rating Organization) registration and qualification process. The SEC has exclusive supervisory and investigatory powers that are necessary for the exercise of its functions. The Commission's rules implementing the Credit Rating Agency Reform Act took effect on June 26, 2007.

A CRA will be able to register with the SEC if the CRA has been in business as a credit rating agency for at least the past 3 consecutive years and issues credit ratings certified by at least 10 qualified institutional buyers.

The application for registration must contain information on:

- The credit ratings performance measurement statistics;
- the rating procedures and methodologies;
- the procedures in place to prevent the misuse of material non-public information;
- the organisational structure of the credit rating agency;
- whether or not the applicant has a code of ethics;
- list of 20 largest issuers and subscribers that use the CRA's services

The SEC must grant registration within 90 days (possible extension to 120) if the requirements are satisfied unless the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies required. This indicates that the oversight of CRAs by the SEC does not cover the substance of the ratings or the procedures by which CRAs determine their ratings. Once registered, each NRSRO must certify every year that it still complies with the registration criteria. The SEC is authorised by the Act to suspend or revoke the registration in case of non-compliance.

On 24th September 2007, the SEC issued orders granting the registrations of seven CRAs as NRSRO. The firms are the first to be registered with the Commission under the CRA Reform Act of 2006. The seven firms registered as NRSROs are: A.M. Best Company, Inc., DBRS Ltd., Fitch, Inc., Japan Credit Rating Agency, Ltd., Moody's Investors Service, Inc., Rating and Investment Information, Inc. and Standard & Poor's Ratings Services.

The US Act on CRAs is relatively recent and therefore there has not been enough time to test its effectiveness; it entered into force just weeks before the burst of the subprime turmoil. However, the SEC has recently proposed important changes in the legal framework for CRAs (see Annex 9.5)

9.2. The financial crisis and the ECOFIN Roadmap

Since August 2007 financial markets worldwide are suffering a critical crisis of confidence. It is generally agreed that the genesis of this crisis originated in the US subprime residential mortgage market⁶³. These mortgages with low underwriting standards were normally grouped in pools of assets and securitised as new products (structured products)⁶⁴ that were sold in the financial markets worldwide. Over 80% of these subprime structured products were rated with the highest ratings by the CRAs.

In summer 2007, financial markets experienced a sudden and turbulent re-assessment of risk by investors, as the default rate on US mortgage loans increased significantly. The rising risk aversion spread to other financial market segments as well, often through collateralised debt obligations (CDOs)⁶⁵, which are frequently based on those high-risk mortgages which experienced serious downgrades. CDOs have been bought in large quantities by financial institutions throughout the world in recent years.

The resulting large losses, and the uncertainty as to who holds the risk, affected inter-bank lending in a negative way, which forced the central banks to provide liquidity to the banking sector in an unprecedented scale. The problems have spread to other segments of the financial system, such as commercial real estate securities, bond insurers and highly leveraged private equity loans, which banks continue to hold, given the lack of other investors interested in buying them.

The origins of the current turbulence have been excessive risk taking derived from low interest rates and the pursuit of high returns. A specific consequence of these unusual favourable financing conditions has been an increase in borrowing for residential housing and a consequent boom in housing markets in many parts of the world. Demand for housing in the US was further fuelled by a generalised relaxation of acceptance criteria for lending, the development of "teaser" loans with relatively low initial reimbursement charges and other financial innovations that have made mortgage financing more accessible. In particular, the existence of a secondary market for mortgage loans (markets where existing loans are sold to other investors) in the United States has made access to mortgage financing possible for borrowers who were not previously deemed creditworthy, either due to a lack of credit history

⁶³ The subprime sector provides housing loans to borrowers who due to their credit history do not qualify for conventional mortgages.

⁶⁴ The original lenders of sub-prime loans bundled the mortgage loans together and sold them to investors as mortgage backed securities – in essence these investors bought securities that would entitle them to a return from these mortgages in return for taking on all or part of the risk. These securities were rated by credit rating agencies and then sold to other financial institutions and investors. The process of packaging and pooling assets like mortgage loans, and selling them to investors as securities is referred to as 'securitisation'. Banks transferred most of these mortgage assets to off-balance sheet entities (so-called structured investment vehicles or SIVs), which financed themselves via short-term loans. This made them vulnerable to a sudden financing disruption if those providing the loans were to lose confidence, which is exactly what happened in August last year.

⁶⁵ Collateralised debt obligations (CDOs) represent a portfolio of different debt receivables. Sub-prime loans were bundled together with other securities – e.g. based on prime mortgage loans or loans raised by companies – to create CDOs. These CDOs are typically subdivided into different risk categories, ranging from very high (junk) to very low risk (AAA). Each tranche is assessed by a credit rating agency and sold on this basis to investors, including hedge funds, pension funds, insurance companies and banks. In this way, the credit risk associated with US sub-prime mortgage loans was distributed around the global financial system.

or previous loan defaults⁶⁶. This was because banks and brokers could sell their sub-prime housing loans to outside investors, who were often willing to buy those loans with a higher interest rate attached in the prevailing low interest rate environment.

An important downside to this development was the potential for widespread defaults and foreclosures among these marginal borrowers in the event of deteriorating broader economic and/or financial conditions which occurred during 2006/2007 as the US housing prices weakened and interest rates rose.

This turmoil has hit Europe through three different channels. Firstly, some EU financial institutions faced losses because they were exposed to the US sub-prime market, e.g. through credit lines on special purpose vehicles that had bought US sub-prime securities⁶⁷. Secondly, the US sub-prime problems have considerably slowed down US growth prospects. Given global trade inter-linkages this affects the EU economic growth as well. Thirdly, the general market uncertainty has eroded equity market prices also in Europe as well as reduced consumer and business confidence. Data on the trend of issuance of structured finance products could be found in annex 9.11.

CRAAs did not create the crisis themselves; however they have contributed to it through the ratings they have attached to individual instruments. CRAAs rate a wide variety of instruments, but especially in the area of complex securitised products they conduct analysis that sometimes investors do not have the means to conduct themselves. This creates a strong dependence on the rating provided by CRAAs. The amount of securitised products⁶⁸ outstanding in Q1 2008 in the US surpassed 6,000 bn EUR, while the amount outstanding in Europe was around 1,200 bn EUR. Of the securitised products issued in Euros in 2007 almost

⁶⁶ The current financial turmoil started in the US. To bring in more home buyers, lenders in the USA began offering mortgages with less scrutiny of the borrower's qualifications and inquiry into the borrower's repayment ability than had been customary in the past. In both 2005 and 2006, lending to this so-called 'sub-prime' segment of the market for residential mortgages represented about 20% of all new US mortgage loans. These sub-prime mortgages provide housing loans to high-risk borrowers with weak credit or a bad credit history that do not qualify for conventional mortgages. Some sub-prime loans were secured by the ability of borrowers to roll-over their debts backed on the value of their houses rather than being based on their ability to repay them. Some sub-prime mortgage contracts had low starting interest rates that would rise over time. After the initial interest rates were reset to much higher interest rates reflecting normal market rates, a significant number of sub-prime borrowers were unable to continue payments. With falling house prices many sub-prime borrowers could not sell or refinance their mortgage as they owed more than their house was worth: delinquency and foreclosure followed. Sub-prime mortgages are generally only sold in the US and are relatively uncommon in the EU.

⁶⁷ Problems in the credit markets have had serious implications for the global banking system. Many of the most important international banks are exposed to credit risk from collateralised debt obligations (CDOs). As problems in CDO markets have intensified, these banks have incurred significant financial losses through write-downs of their asset valuations. In accordance with data from Bloomberg in mid May, since the beginning of 2007 the biggest banks and securities firms have faced \$379 billion in asset write downs and credit losses (more information in the annex 9.10). While some of the major banks have managed to recapitalise, often by attracting investments from sovereign wealth funds, they remain vulnerable, e.g. to further deteriorations in the CDO markets and existing commitments to finance highly leveraged private-equity deals. Bank profitability also suffers from the financial turmoil, as the outlook for non-interest income deteriorates and loan-loss provisions are set to rise from historical lows.

⁶⁸ These figures cover ABS, CMBS, RMBS and CDO. In the case of CDOs tailor-made (typically non-public) issues and issues with a significant element of derivatives in the underlying assets are not included due to data limitations.

90% were rated and of these more than 75% were rated AAA. In the US approximately 43% of the issuance was rated (excluding Agency MBS⁶⁹) and of this 62% was rated AAA. The high proportion of AAA rated securitised products, which may have given investors a certain degree of reassurance and contributed to the buy-decision, clearly demonstrates the importance of ratings. The figures show that CRAs have by far failed more when assigning structured ratings than when issuing traditional ones (corporate, sovereign). During the period 1 July, 2007 to 24 June, 2008, CRAs have downgraded 145,899 structured ratings compared with 1,445 in corporate ratings in the same period⁷⁰. Hence, the problem has affected more the structured finance segment.

Downgrades hit historical numbers only from the 3Q 2007 onwards, when financial turbulences started. Each CRA reached its biggest number of downgrades in structured ratings in a different month. For instance, S&P registered 13,734 downs in January 2008. The maximum in Fitch came in February 2008 with 8,165 downgrades. Finally, the worst month for Moody's was April when the CRA experienced not only an internal record but also a record among the CRAs by downgrading 15,015 issuances⁷¹.

During the financial crisis there has been a considerable shift in the changes of ratings for structured finance products. In the first half of 2007 Standard & Poor's reported 176 upgrades of European issues and 134 downgrades. In the second half of 2007 they reported 167 upgrades but 225 downgrades, and in the first quarter alone the number of upgrades was only 44 while the number of downgrades was 482. In the US downgrades in relation to sub-prime has followed a similar but even more severe pattern. Standard & Poor's has reported, in 2007, a total of 1532 upgrades and 6535 downgrades. In the first quarter of 2008 there were 216 upgrades but 8895 downgrades. The number of upgrades/downgrades in 2007 and first quarter of 2008 for Fitch totalled 516/275 in the EU and 2093/10.917 in the US respectively; for Moody's totalled 304/507 in the EU and 1714/14.406 in the US, respectively; and for Standard and & Poor's totalled 387/841 in the EU and 1748/15.430 in the US, respectively.

The massive downgrading of securitised products has hampered the market's confidence in CRAs. At any given point in time a limited number of upgrades and downgrades would be expected, and as general economic conditions deteriorate a moderate increase in the net number of downgrades would be expected. However, the massive downgrading that has occurred seems to suggest that the rated products have been constructed in such a way that they have barely met the criteria for a certain rating at the time of issuance and/or the assessment of the probability of default or expected loss was unrealistic.

More data on the impact of the crisis on the economic activity in terms of asset write-downs and credit losses in the credit entities can be found in annex 9.10.

In order to respond to the financial turmoil and to address the causes of that crisis EU Finance Ministers in October 2007 agreed to a set of conclusions ("Ecofin Roadmap"). One of the main actions proposed is to assess the role played by CRA in particular with regard to structured financial instruments and to address any relevant deficiencies. More specifically, the Commission was asked to examine possible conflicts of interest in the rating process,

⁶⁹ Mortgage bonds which are guaranteed by a Government agency or Government-sponsored enterprise such as Fannie Mae or Freddie Mac.

⁷⁰ Source: Bloomberg.

⁷¹ Source: Bloomberg.

transparency of rating methods, time-lags in rating reassessments and regulatory approval processes.

9.3. Definitions

For the purposes of this document, the following typology of products is used. The typology is not intended to have any official status.

There is a great variety of instruments that could fall within the broad category of ‘securitised products’. The main categories are:

- **ABS:** asset-backed securities. Securities issued against the revenues from an underlying pool of assets which are used as collateral.
- **ABCP:** asset-backed commercial paper. This type of ABS has a maturity of less than one year when issued. ABCECP refers to asset-backed Eurocommercial paper, and refers to ABCP issued in the EU. In the rest of this paper, the terms ‘ABS’ and ‘ABCP’ are used in a mutually exclusive sense;
- **CDS:** credit default swaps. These are cash-settled derivative instruments whose payout function depends on the performance in ratings terms of a reference credit (often an investment-grade issuer).

The various types of collateral underlying ABS include:

- residential mortgages, underlying residential mortgage-backed securities (RMBS);
- commercial mortgages, underlying commercial mortgage-backed securities (CMBS);
- auto loans;
- credit card receivables;
- leases: including equipment and other leases;
- loans: including leveraged, commercial, consumer, corporate and other loans;
- receivables: including account, health care, insurance, oil, utility and other receivables;
- mixed underlying assets, where the ABS is referred to as a collateralised debt obligation (CDO). One important type of CDO is collateralised loan obligations (CLOs), a specific type of CDO whose underlying assets are leveraged loans or middle market loans only. Synthetic CDOs achieve credit exposures to debt instruments through credit derivatives.

9.4. Overview of the organization and structure of the big CRAs. List of CRAs

Standards and Poor's

1. Structure of S&P in the EU

Standard & Poor's Ratings Services is not a legal entity. It is a separately identifiable division of Standard & Poor's, itself a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), a U.S. publicly listed publishing and information services group.

Outside the U.S., Ratings Services does business through a number of local subsidiaries of McGraw-Hill reflecting differences in local requirements, including legal and fiscal requirements. Provided below is a list of McGraw-Hill entities in the European Union through which Ratings Services operates, including branches, divisions and subsidiaries that are wholly owned by McGraw-Hill.

- Standard & Poor's España, S.A. (Spain)
- McGraw Hill International (U.K.) Limited (UK)
- Standard & Poor's AB (Sweden)
- The McGraw-Hill Companies GmbH (Germany)
- The McGraw-Hill Companies, SA (France)
- The McGraw Hill Companies, SRL (Italy)

2. Number of people working for S&P in the EU and in each subsidiary

As of the end of June 2008, Standard & Poor's staff total in the European Union was approximately 1,000. This number included approximately 535 staff in Ratings Services, including analysts, managers and analytical support staff operating out of offices in France (Paris), Germany (Frankfurt), Spain (Madrid), Italy (Milan), Sweden (Stockholm) and the UK (London). The numbers of Ratings Services staff within those offices are the following: France approximately 70; Germany approximately 70; Italy approximately 25; Sweden approximately 20; Spain approximately 25 and the UK approximately 325. These figures for staffing levels represent actual staff and do not include open positions.

3. Presence in EU markets:

Standard & Poor's 2007 market penetration was 79% for all rated European debt.

4. Number of new ratings per product in the EU on a quarterly basis since 2006.

EU New Issue and Issuer Ratings

	Corporates	Sovereigns & Public Finance	Structured Finance
Q1 2006	34	0	618
Q2 2006	10	0	381
Q3 2006	30	1	568
Q4 2006	26	1	676
Q1 2007	24	0	965
Q2 2007	26	0	578
Q3 2007	35	0	908
Q4 2007	30	3	551
Q1 2008	30	0	338

Moody's Investors Service ("MIS")⁷²

1. Moody's Investors Service Offices (excluding affiliates) in the European Union as at of 11 July 2008:

- Moody's Investors Service Cyprus Limited (Limassol, Cyprus)
- Moody's Investors Service Ltd (London, United Kingdom)
- Moody's Investors Service Ltd (Madrid, Spain)
- Moody's Italia S.r.l (Milan, Italy)
- Moody's France SAS (Paris, France)
- Moody's Deutschland GmbH (Frankfurt am Main, Germany)
- Moody's Central Europe a.s. (Prague, Czech Republic)

2.1 Number of people working for Moody's (global staffing as at 31 December 2007):

	United States	International	Total
Moody's Investors Service	1,869	1,284	3,153

2.2 Number of people working for MIS in the EU and in each subsidiary

MIS has some 550 staff employed in the EU of which 65% are employed in the UK, 12% in Germany, 10% in France and the remaining 13% across other EU offices.

⁷² Moody's has reorganised its operating businesses to formalise the separation of the ratings-related and non-rating activities into two different business units – Moody's Investors Service, the ratings related business, and Moody's Analytics, the non-rating activities business. The information in this document refers only to MIS

3. Revenue for MIS for year ended 31 December (U.S. \$millions):⁷³

	2007
United States	1,119
EU	451
Other	210
Global Total	1,780

4.1. Number and issuance volume of selected new public structured finance ratings in the EU in 2007⁷⁴

	Total Number	Volume
ABS, RMBS, CMBS deals	246	€489.16 billion
CDO deals	128	€46.21 billion
Covered Bond Programmes	23	-

4.2 ABCP data as at 31 December 2007⁷⁵

	Total Asset Split in EU(US\$bn) ⁷⁶
ABCP	200.57

4.3 Number of MIS public bank ratings in the EU as at 4 March 2008

	Total
EU Bank Ratings	529 ⁷⁷

⁷³ The global nature of capital markets makes it difficult to assign ratings/underlying assets to a particular jurisdiction and many deals have exposure to numerous jurisdictions globally thus affecting the accurateness of European Union-specific data. The EU information is not audited and has been provided for this Impact Assessment on a best efforts basis. Moody's does not segment EU revenue and does not report it externally.

⁷⁴ Includes all MIS rated public deals in the EU. Excludes EU deals with global assets.

⁷⁵ ABCP figure includes ABCP issued by conduits administered by banks operating through their EU branches and rated by MIS. Excludes EU deals with global assets.

⁷⁶ The asset amount represents the actual amount of assets funded via ABCP and other sources (not including cash and short-term investments).

⁷⁷ This figure constitutes the total number of MIS public rated issuers domiciled in the European Union. The total number should be considered in the context of:

- Including EU-domiciled legal entities in the form of, for example, finance vehicles, where the ultimate exposure may rest with an associate company in another jurisdiction or with an associate

4.4 Number of MIS public ratings in the EU as at 31 December 2007 for selected business lines

	Total
Corporate Finance	955 ⁷⁸
Financial Institutions (Excl. Banks)	306 ⁷⁹
Sub-sovereign (Excl. Sovereign)	173 ⁸⁰
Managed Funds	248

5. Revenue for Moody's Corporation (incorporating Moody's Investors Service and Moody's Analytics) for year ended 31 December (\$ millions):

	2007	2006	2005
United States	1,361.8	1,277.8	1,085.4
Europe	659.3	543.9	456.0
Other	237.9	215.4	190.2
Total	2,259.0	2,037.1	1,731.6

6. Global revenue for Moody's Investors Service for the year ended 31 December (\$ millions):

	2007	2006	2005
Structured Finance	885.9	883.6	708.7
Corporate Finance	411.5	335.9	277.4
Financial Institutions	261.7	222.1	214.0

company in another EU jurisdiction;

- Including ratings assigned to subsidiary companies of a parent company that also maintains a credit rating and where the ultimate exposure may rest with the parent company in another jurisdiction or with a parent company in another EU jurisdiction;

- Certain ratings may be inextricably linked to the rating of the parent but since they have separately assigned ratings, are counted as two or more separate ratings.

⁷⁸

See previous footnote.

⁷⁹

Includes Insurance, Finance & Other non-bank. See previous footnote.

⁸⁰

As at 9 May 2008.

Public, Project and Infrastructure Finance	220.8	198.2	184.8
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Fitch Ratings

Fitch operates through subsidiaries in the EU. The subsidiaries outside the UK are owned by Fitch Ratings Ltd. of the UK, itself owned by Fitch, Inc. of the US. These are the subsidiaries of Fitch Ratings in the EU:

- Fitch Ratings Limited (UK)
- Fitch Ratings CIS Limited (UK)
- Fitch Ratings España S.A.U (Spain)
- Fitch Ratings Deutschland GMBH (Germany)
- Fitch France (France)
- Fitch Italia S.P.A. (Italy)
- Fitch Polska S.A. (Poland)

2. Number of people working for Fitch Ratings in the EU

The European staff of Fitch comprised 678 employees at September 2007, from a worldwide total of 2.361. This includes offices in Istanbul, Moscow and Tunisia which are outside the EU but where the staff is engaged on pan-European rating assignments.

3. Revenues in the EU

Fitch does not publish geographical breakdowns for the EU. In 2007 the revenues of Fitch in Europe, the Middle East and Africa were \$332.5m (40% of global Fitch Ratings revenue of US\$ 827.4m. In the first half of 2008 the European revenues of Fitch totalled US\$145.6m, or 43% of global Fitch Ratings revenue (US\$ 335.5m).

4. New ratings in the EU, 2006-07

		Public Finance	Structured Finance*	Corporate Finance
2006	Q1	2	71	23
	Q2	4	164	29
	Q3	7	155	27
	Q4	12	174	106**
2007	Q1	4	87	30
	Q2	8	150	23

	Q3	5	136	17
	Q4	7	61	28

* 998 transactions, containing 4.279 tranche ratings

** Includes 64 ratings assigned simultaneously to Volksbank-Verbund system banks within Austria.

Global List of CRAs in April 2008

(Source: www.defaultrisk.com)

- (1) A.M. Best Company, Inc.
US -- NRSRO
- (2) Agusto & Co. Ltd.
Nigeria
- (3) Ahbor Rating
Uzbekistan
- (4) Apoyo & Asociados Internacionales S.A.C.
Peru -- Fitch Associate
- (5) Bank Watch Ratings S.A.
Ecuador -- Fitch Affiliate
- (6) BRC Investor Services S.A.
Columbia
- (7) Calificadora de Riesgo, PCA
Uruguay
- (8) Capital Intelligence, Ltd.
Cyprus
- (9) Caribbean Information & Credit Rating Services Ltd. (CariCRIS)
Caribbean
- (10) Central European Rating Agency (CERA)
a/k/a: Fitch Polska, S.A.
Poland
- (11) Chengxin International Credit Rating Co., Ltd.
China -- Fitch Affiliate
- (12) China Lianhe Credit Rating, Co. Ltd.
China
- (13) Clasificadora de Riesgo Humphreys, Ltda.
Chile -- Moody's Affiliate
- (14) Class y Asociados S.A. Clasificadora de Riesgo
Peru
- (15) CMC International, Ltd.
Nigeria
- (16) Companhia Portuguesa de Rating, SA (CPR)
Portugal

- (17) Credit Analysis & Research Ltd (CARE)
India
- (18) Credit Rating Agency of Bangladesh, Ltd. (CRAB)
Bangladesh
- (19) Credit Rating Information and Services, Ltd. (CRISL)
Bangladesh
- (20) CRISIL, Ltd.
f/k/a: Credit Rating Information Services of India
India -- S&P Affiliate
- (21) Dagong Global Credit Rating Co., Ltd.
China
- (22) Dominion Bond Rating Service (DBRS)
Canada -- NRSRO
- (23) Duff & Phelps de Colombia, S.A., S.C.V
Columbia -- Fitch Affiliate
- (24) Ecuability, SA
Ecuador
- (25) Egan-Jones Rating Company
US -- NRSRO
- (26) Equilibrium Clasificadora de Riesgo
Peru -- Moody's Affiliate
- (27) European Rating Agency (ERA)
UK
- (28) Feller Rate Clasificadora de Riesgo
Chile -- S&P Affiliate
- (29) Fitch Ratings, Ltd.
US/UK -- NRSRO
- (30) Global Credit Rating Co.
S.Africa
- (31) Interfax Rating Agency (IRA)
Russia
- (32) Investment Information and Credit Rating Agency (ICRA)
India
- (33) Islamic International Rating Agency, B.S.C. (IIRA)
Bahrain

- (34) Japan Credit Rating Agency, Ltd. (JCR)
Japan -- NRSRO
- (35) JCR-VIS Credit Rating Co. Ltd.
Pakistan -- JCR Affiliate
- (36) Korea Investors Service, Inc. (KIS)
Korea -- Moody's Affiliate
- (37) Korea Ratings Corporation
f/k/a: Korea Management Consulting and Credit Rating Corp. (KMCC)
Korea -- Fitch Affiliate
- (38) Lanka Rating Agency, Ltd. (LRA)
Sri Lanka -- Subsidiary of RAM
- (39) Malaysian Rating Corporation Berhad (MARC)
Malaysia -- Fitch Affiliate
- (40) Mikuni & Co., Ltd.
Japan
- (41) Moody's Investors Service
US -- NRSRO
- (42) National Information & Credit Evaluation, Inc. (NICE)
Korea
- (43) ONICRA Credit Rating Agency of India, Ltd.
India
- (44) P.T. Kasnic Credit Rating Indonesia -- Indonesia
Indonesia -- Moody's Affiliate
- (45) P.T. PEFINDO Credit Rating Indonesia
a/k/a: PT Pemeringkat Efek Indonesia
Indonesia
- (46) Pacific Credit Rating (PCR)
a/k/a: Clasificadora de Riesgo Pacific Credit Rating S.A.C.
Peru
- (47) Pakistan Credit Rating Agency, Ltd. (PACRA)
Pakistan -- Fitch former affiliate
- (48) Philippine Rating Services, Corp. (PhilRatings)
Philippines
- (49) RAM Rating Services Berhad (RAM)
f/k/a: Rating Agency Malaysia Berhad
Malaysia -- S&P Affiliate

- (50) Rapid Ratings International, Inc.
Australia/NZ
- (51) Rating and Investment Information, Inc. (R&I)
Japan -- NRSRO
- (52) Rus Ratings
Russia
- (53) Seoul Credit Rating & Information, Inc.
Korea -- JCR Affiliate
- (54) Shanghai Credit Information Services Co., Ltd.
China
- (55) Shanghai Far East Credit Rating Co., Ltd.
a/k/a: Xinhua Far East Credit Ratings
China
- (56) Slovak Rating Agency, a.s. (SRA)
a/k/a: Slovenská ratingová agentúra, a.s.
Balkans -- ERA Affiliate
- (57) SME Rating Agency of India Limited (SMERA)
India
- (58) Sociedad Calificadora de Riesgo Centroamericana, S.A. (SCRiesgo)
Costa Rica
- (59) Standard and Poors (S&P)
US -- NRSRO
- (60) Taiwan Ratings, Corp. (TCR)
Taiwan -- S&P Affiliate
- (61) Thai Rating and Information Services Co., Ltd. (TRIS)
Thailand
- (62) TheStreet.com Ratings, Inc.
f/k/a: Weiss Ratings, Inc.
US
- (63) Türk KrediRating (TCRating)
Turkey
- (64) Veribanc, Inc.
US

9.5. Consultation: CESR, ESME, IOSCO, FSF, SEC

The European Commission decided to mandate CESR in September 2007 and ESME in November 2007, to provide advice on the various aspects of CRAs' activity and role in the financial markets and especially in structured finance. The Commission services followed the work of both groups throughout the entire process. Both groups have carried out an extensive consultation with stakeholders notably on the role of structured finance in the context of the subprime turmoil. CESR delivered its report on 13 May 2008 and ESME delivered its report on 4 June 2008.

Apart from closely following the progress of work at CESR and ESME, the Commission services have held discussions with major rating agencies and other stakeholders (industry associations from the insurance, securities and banking sectors, information providers, etc). The Commission services have also received written inputs from a wide range of associations, market practitioners and stakeholders. On the international side, the Commission services have followed closely the developments like the revision of the code of conduct for CRAs approved by IOSCO on 26 May 2008, the report of the Financial Stability Forum (FSF)⁸¹ published on 7 April 2008 and the proposal for changes in the US Act on CRAs presented on 11 June 2008. The Commission services have been also following the consultations carried out by both IOSCO and the FSF.

In the following a summary of the content of the different reports and initiatives is given:

9.5.1. CESR report

In the Communication from the Commission on CRAs of 2006 CESR was asked to monitor CRAs' compliance with the IOSCO Code and report back to the Commission on an annual basis. CESR published the first annual report in December 2006⁸². The conclusion of this first report was that – despite some non-essential deviations – the main CRAs had implemented the IOSCO code.

In May 2007, the European Commission asked CESR to monitor again the voluntary compliance of CRAs with the IOSCO Code and to prepare a second report on the topic. In September 2007 the Commission requested CESR to expand this report to review the role of CRAs in structured finance and re-evaluate regulatory options in this area. In February 2008 CESR published a consultation paper⁸³ ahead of preparing the report mandated by the COM. CESR has also held a public hearing on 26 March 2008. The public consultation on the draft findings was concluded with a significant number of contributions from market participants.

⁸¹ The Financial Stability Forum was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The Forum brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk.

⁸² CESR's Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code. December 2006 (CESR/06-545)

⁸³ The role of credit rating agencies in structured finance. Consultation Paper. 13 February 2008

CESR Chairmen approved the final advice for the Commission in the plenary of Ljubljana (13 May 2008)⁸⁴.

CESR's report is divided in four sections:

1. Summary of the main initiatives in the international market in relation to the role of CRAs in the structured finance sector (EU countries, Capital Requirements Directive, US, FSF, IOSCO, CRAs initiatives, ESME, CGFS)
2. Recommendations to CRAs in relation to the areas of:
 - *Transparency*: CRAs should communicate the characteristics and limitation of the ratings; should give information on critical model assumptions; ratings should label the methodology used; information on rating performance should be provided in a standardised, publicly available format to the market.
 - *Human Resources*: CRAs should disclose selective human resources indicators; CRAs should ensure that remuneration structures are appropriate to promote independence and avoid conflicts of interest.
 - *Monitoring of Ratings*: CRAs should ensure that the monitoring of their ratings remains effective.
 - *Conflicts of Interest*: CRAs should ensure full transparency with regard to the exact nature of their interaction with issuers/arrangers of structured finance products as this interaction can give rise to conflicts of interest; CRAs should have strong policies and procedures in place to monitor and control this interaction ; there should be a common definition on what constitutes advisory practice and a definition of what constitutes ancillary business; CRAs should be transparent in the disclosure of the fees they receive from issuers.
3. Monitoring of compliance of the CRA's codes of conduct on those provisions of the CRAs' codes that CESR identified in its first report (January 2007) as areas of non-compliance with the IOSCO Code: CESR conclude that the four big CRAs⁸⁵ internal codes of conduct comply to a large extent with the IOSCO Code, but there are still areas where the CRAs' internal codes of conduct could be improved; thus, the initiatives undertaken by the CRAs are insufficient.
4. CESR's proposal to the European Commission: CESR considers that IOSCO (as revised) should be regarded as the minimum upon which an enhanced framework should be built. However, CESR makes several additional recommendations (see above point 2). CESR recommends the Commission "to form, as an immediate step, a CRAs standard setting and monitoring body with the following objectives:
 - a) to develop international standards for the rating industry in line with the steps taken by IOSCO;

⁸⁴ CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008 (CESR/08-277)

⁸⁵ CESR report analysed the codes of conduct of Standard and Poor's, Moody's, Fitch and DBRS (see section 1.3)

- b) to monitor the compliance of CRAs to those standards, using full transparency as the method for enforcement and having “name and shame” capacity.

The members of the body should be senior representatives of investors, issuers, investment firms and CRAs (the latter only for the standard setting function). They would be appointed in their majority by the international regulatory community to ensure independence.

9.5.2. *ESME report*

In November 2007 the Commission requested ESME's advice on certain issues concerning the role of CRAs and the importance of ratings in the financial markets, and in particular in the field of structured finance. The report of ESME was approved on 4 June. It covers CRAs' operations and role on the markets, business incentives, internal organisation implications and market dynamics.

ESME's report discourages a regulatory approach for CRAs by the EU institutions. While they are concerned with the lack of CRAs' accountability towards the market, they are equally concerned by possible adverse results of a tighter regulatory regime. The self-regulatory regime already in place could still work but, in any event, the IOSCO code should be revised. Nevertheless, there is a need of further developments or requirements in certain areas going beyond the revision of the IOSCO code. Therefore, implicitly the report is advocating for a European code of conduct built upon IOSCO's.

The report contains very detailed recommendations on methodology and analytics:

- CRAs should agree with market participants on the information that should be disclosed on a pool of assets being securitized; CRAs should disclose the fee structure for rating the security.
- The report makes a strong point on corporate governance; notably, each CRA should have an independent policy function accountable for policy, criteria, models and quality assurance; this policy function should report to a policy sub-committee of the Board, composed by a majority of non executive directors whose compensation would be a fixed fee; the chief executive officer and the chairman of the board should be different persons.
- Concerning the oversight, the report considers that CESR should keep its monitoring role in relation to CRAs; nevertheless, this role should be reinforced by an annual external auditory on corporate governance in each CRA and by an advisory group that would advise CESR on:
 - a) significant developments, trends and issues in the credit markets which are relevant to the activities of the CRAs, and;
 - b) any rating trends/issues which are prompting concerns.
- Membership of this group would comprise investors/users, issuers, originating banks, sponsoring banks, credit experts, academic risk experts and the Securities and Exchange Commission (SEC).

9.5.3. *Revision of the IOSCO code on CRAs*

On 26 March 2008 the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published a consultation paper on the role of CRAs in structured finance markets. After collecting evidence from market participants, the revision of the Code of Conduct Fundamentals for CRAs of 2004 was approved by the IOSCO Chairmen in IOSCO's Annual Conference, held in Paris on 26-29 May.

The IOSCO report describes the actual role played by the rating agencies in the credit markets (and structured finance markets in particular). It looks at the areas where deficiencies in the CRAs' practices were observed (transparency, conflicts of interest and integrity and competition issues). The paper does not present particularly strong criticisms against the CRAs (in the context of the subprime crisis) but rather identifies the need to make adjustments to the IOSCO Code of Conduct in order to better address the legitimate concerns related to the activity of the agencies (quality and integrity of the rating process; CRA independence and avoidance of conflicts of interest; CRA responsibilities to the investing public and issuers; and disclosure of the CRA's code of conduct and communication with market participants).

The report first offers a descriptive presentation of the CRAs' role in the structured finance markets. It notes the overwhelming reliance of market participants on the ratings (even sophisticated institutions with capability to double-check the CRA analysis do not do it, as it is time consuming). The fact that the CRA analysis is model-based and largely quantitative has also strengthened the common perception of objectivity of their opinion. The ratings have consequently become a seal of approval (rather than merely a third party opinion of the loss characteristics of the security). In this context the report notes that agencies rely entirely on the data provided by the issuers or even 3rd parties and that their methodologies do not take into consideration changes that may have an impact on the quality of the information they receive. Moreover, CRAs' analytical capacity is weakened in this area because of some specific difficulties with assessing structured finance instruments:

- difficulty to analyse correlation risk within a portfolio of similar loans (further compounded in the case of CDOs),
- lack of secondary market data,
- limited historical performance data,
- no universal valuation method and price discovery mechanism for structured finance instruments.

The IOSCO report recognises that the prominence of the CRAs' opinions was further strengthened as a result of Basel II⁸⁶.

⁸⁶ The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures (In the EU is mandatory since January 2008). It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. In addition, the Basel II Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop or improve their ability to manage those risks. As a result, it is intended to

The IOSCO report identifies a number of deficiencies in the operations of CRAs which should be considered from a regulatory perspective:

- Transparency issues: (i) historical performance data are not sufficiently transparent and comparable; (ii) there are major differences between corporate and structured finance ratings (in terms of methodology, data series available, and liquidity considerations); (iii) there is a lack of clarity in terms of CRAs' policies regarding the reviews of past ratings and methodologies.
- As for independence and measures to avoid conflicts of interest, the report reminds the ever-present concerns related to the issuer-pays model (becoming even more acute in the case of structured finance) and the advisory services that could be inadvertently offered by the CRAs, but does not go beyond proposing complementing measures to the existing Code of Conduct provisions.
- When addressing competition issues, the IOSCO report reiterates the view that reputation, which needs to be earned from users of ratings, may be a more difficult to overcome as a barrier of entry than (potential) regulatory disciplines. It recognises that the inherently less transparent structured finance markets and limited competition among CRAs may combine to undermine the integrity of the credit rating process of these products.

The amendments to the IOSCO Code may be grouped as follows:

a) Conflicts of interest, integrity and governance:

- CRAs should prohibit analysts from making proposals or recommendations regarding the design of structured finance products rated by the agency;
- CRAs should have "look back" policies (when an analyst leave the agency and joins an issuer that he was rating, the agency would review his last year activity);
- CRAs should periodically review the remuneration policies and practices for the employees, so that they do not compromise the CRA's rating process;
- CRAs should disclose whether any client make up more than 10 percent of the CRA's annual revenue;
- CRAs should define what it considers and does not consider to be an ancillary business and give the reasons therefore.

b) Transparency of CRA methodologies and ratings:

- CRAs should use a separate set of rating symbols for rating structured finance products;
- CRAs should disclose the rating methodology that they use for each product.

c) Quality of ratings:

be more flexible and better able to evolve with advances in markets and risk management practices. (Excerpt from the Bank of International Settlements website).

- The decision-making process for reviewing a rating (and potentially downgrading it) should be objective;
- CRAs should have an independent function for the periodic review of the methodologies and models;
- CRAs should ensure that the information they use is of sufficient quality to support a credible rating; ratings involving products with limited historical data (like subprime mortgages) should have these limitations made clear;
- CRAs should refrain from rating a product if the complexity or structure of a new type of rating makes the rating not feasible.

d) Investor education:

- CRAs should give investors more information about what a credit rating is, its attributes and limitations, and should inform to what extent it verifies the information provided to it by the issuer;
- CRAs should provide investors/subscribers with all necessary information for them to understand the basis for the CRA's rating when rating a structured finance product.

9.5.4. *Financial Stability Forum*

In its report of 7 April 2008 the FSF examines the causes and weaknesses that have produced the current financial turmoil and sets out recommendations for increasing the resilience of markets and institutions going forward. The FSF recommendations in the area of CRAs have been based substantially on the inputs of IOSCO and Committee on the Global Financial System (Bank of International Settlements). They suggest improvements in the following areas:

- CRAs should implement the revised IOSCO Code to manage conflicts of interest
- CRAs should improve the quality of the rating process with periodic reviews of methodologies and models undertaken by an independent function;
- CRAs should separate consulting and rating activities;
- CRAs should have adequate resources in the initial rating and in the review function
- CRAs should differentiate ratings on structured products from traditional ones (different scales or additional symbols).
- CRAs should expand the initial and ongoing information (assumptions, volatility of the rating, and limitation of analysis due to insufficient data or untested models).
- CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.
- Investors should address their over-reliance on ratings (investors' due diligence).

- Regulators should review their use of ratings in the regulatory and supervisory framework (in order to avoid inducement to uncritical reliance on ratings).

The FSF report welcomes the steps that have been made, individually and collectively, by the CRAs⁸⁷ to address some of the problems but suggests that 'more is needed'.

9.5.5. *US Securities and Exchange Commission (SEC) proposal*

The U.S. Credit Rating Agency Reform Act of 2006 entered into force on 27 June 2007. This new Act establishes a legal framework for a revised voluntary NRSRO (Nationally Recognized Statistical Rating Organization) registration and qualification process. The SEC has exclusive supervisory and investigatory powers for the exercise of its functions.

On 13 March 2008 the U.S. President's Working Group (PWG) announced a set of measures involving CRAs in order to enhance integrity and transparency on the rating process for structured credit products. The SEC presented the broad lines of its proposal on CRAs on 11 June 2008. The SEC intends to implement the US Act on CRAs to better address conflicts of interest, quality of ratings and transparency:

- Rating analysts should not be involved in the structuring of a product;
- CRAs shall improve their transparency (public disclosure of rating actions, publication of periodical performance statistics) in a way to allow users to compare among rating agencies;
- CRAs shall disclose the frequency of the revision of ratings and shall be more transparent in the event of a revision of a rating;
- CRAs shall use adequate information about the underlying assets of a product that they are rating; they shall refrain from issuing a rating if the information on the underlying assets is not available and they shall disclose the due diligence performed to verify the information on the underlying assets;
- CRAs shall disclose all the information that they use to produce a rating (including information on the underlying assets), so as to allow broad market scrutiny, as well as competitive analysis by other rating agencies that are not paid by the issuer to rate the product;
- Analysts participating in determining a credit rating should refrain from negotiating the fee that the issuer pays for it (to avoid "shopping for ratings").
- Analysts cannot receive gifts from issuers in any amount over \$25.
- CRAs should differentiate ratings for structured products than ratings for traditional debt (corporate, sovereign), by using different symbols or by disclosing the differences between ratings of structured products and other securities.

On 1 July 2008 the SEC made public for consultation a package of amendments in the US legislation with the aim to review all references to NRSRO ratings in US financial Law. SEC

⁸⁷ See section 5.2.

considers that these references in the legislation might have contributed to an undue reliance on NRSRO ratings by market participants. Investors should improve the analysis of risks and should have clear the limits and purposes of credit ratings for structured products. The proposal is divided in three kind of measures:

- Amend various rules and forms under the Securities Exchange Act of 1934 ("Exchange Act") to remove several references to NRSROs;
- Replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on security ratings with alternative requirements;
- Amend five rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that rely on NRSRO ratings.)

9.6. Excerpts from ESME and CESR report in relation to the role of CRAs, its business model and the meaning of ratings. References to the reports in the text.

Role of CRAs and importance of ratings (pages 3 to 5 of ESME's report)

CRAs are recognised as independent providers of credit opinions and they play an important role as their ratings are used by investors, borrowers, issuers and governments for a variety of reasons. For example, investors use ratings to determine their investment appetite; and governments require ratings in their financial markets and banking supervision regulation.

Investors vary in terms of their own credit research capacity and accordingly the level of reliance placed on CRAs in the purchase of credit assets. Given the scale of the total outstanding rated debt (estimated at US\$40 trillion) the reliance on the CRAs in this regard has been very substantial.

The CRA landscape is by and large diverse with a number of CRAs, but the three most recognised are Standard & Poor's, Moody's Investors Service and Fitch Ratings. Between them, they effectively dominate the market. There are also a number of local and well established agencies in Japan and Canada as well as niche rating agencies such as AM Best in insurance in the US.

Business models of CRAs

The three CRAs above make all their public ratings on issuers available to the market free of charge on their websites, operating under the "issuer pays" model. Alternative business models, typically described as "investor pays", rely upon subscription revenues and thus the release of ratings to only those parties who have subscribed to that rating service. There has been a rapid growth in the number of structured finance transactions, which is reflected in the CRAs' revenues: CRAs currently earn approximately 50% of their revenue from structured finance ratings.

A corporate would typically have two or three CRAs rating their debt and an annual fee is paid to each. In contrast, structured finance issuers would pay the bulk of the fee upfront with a modest annual surveillance fee. A portion of the up-front fee may be recognised on a deferred basis, where part is deemed to cover subsequent surveillance cost. Structured finance usually has more than one rating; exceptions include the use of securities in the repo market where the ECB only demands one rating. ESME's general view is that in principle, structured finance products should have more than one rating, unless there are specific commercial reasons for having just one. The increased number of rating opinions would improve the quality of the ratings, decrease the risk of conflict of interest and improve investor information.

Meaning of ratings

A. Definitions

A credit rating is a current opinion and measure of the risk of an obligor with respect to a specific financial obligation based on all available information. For this purpose, S&P and Fitch define risk as the probability of default (PD), whereas Moody's define it as 'loss', which is the product of PD and the loss rate given default.

The CRAs emphasise that the rating is a relative measure of risk, i.e. BBB+ is a higher risk than A-, but better than BBB. It is not intended to be an absolute measure of risk; therefore, it does not mean that a specific rating, e.g. BBB, which for structured finance securities has had an average default rate of 0.18% between 1987 and 2007, is a mathematical prediction of the future PD. This is an area where there is probably an understandable disconnect with the users of ratings where they tend to take the historic long-term default experience by rating category as an indicator or a measure of future default.

The CRAs state that ratings have the same meaning across asset classes (corporates, sovereigns and structured finance); therefore, the long-term default experience through the economic cycle should be similar.

The appropriate measure of a CRA's rating success is whether, at a portfolio level over the long-term, its ratings are correlated with the actual default experience. An individual corporate collapse, which was not anticipated by the CRAs, is not in isolation an appropriate measure of success or failure. An individual rating is ultimately an opinion, with a default probability, and should never be viewed as a 'certainty', i.e. a total absolute endorsement of a particular security, even if it is rated AAA/Aaa.

B. Differences between corporate vs. structured finance products

The two broad non-sovereign categories of debt rated by the CRAs are corporate and structured finance. While the CRAs indicate the rating of corporate debt and structured finance is similar, the rating issues are arguably fundamentally different. The characteristics of both and the differences, which have relevance from a rating perspective and ESME's mandate, are addressed below.

Corporate debt

- *Corporate debt is essentially a single asset to the investor, although there may be senior and junior debt as well as short-term debt all of which may have separate ratings.*
- *There is generally a relationship dimension between the CRA and management, which usually extends over many years.*
- *Typically, the CRA would deploy an industry specialist with extensive knowledge of the industry. This 'macro' perspective places the analyst in a strong position to evaluate the 'business risk'.*
- *The rating reflects a judgement on the overall balance between the business' risk and financial risk (essentially leverage).*
- *While the gearing level can change substantially over the life of the debt it may be constrained by bank/bond covenants. The CRAs have in any case benchmark leverage ratios which indicate how the rating may respond to changed leverage levels.*
- *If a credit problem arises there are a range of remedies and management have the flexibility to respond to changes in the climate in which they are operating, e.g. the corporate may decide to raise new equity to address credit deterioration. This flexibility is typically not a feature of structured finance.*

Structured finance debt:

- *A structured finance security is usually an obligation of a Special Purchase Vehicle (SPV), which has a pool of assets; these assets will typically have been sold by an originator into the SPV. The loan obligations underlying an individual structure are typically from a single asset class, e.g. prime or subprime residential mortgages, commercial mortgages, credit card receivables, LBO loans, etc.*
- *Typically, the originator wishes to maximise the borrowing against the portfolio, subject to acceptable pricing on the debt. The level of debt that is acceptable to the market on the portfolio is essentially a function of the projected cash flow from the underlying loan assets relative to the debt service obligations on the SPV debt, taking account of stress scenarios. This takes account of the quality of the underlying assets (which reflects, inter alia, the original borrower LTV), the underlying interest spread, projected amortisation speed, etc. This then determines the level of equity that is required; in the case of credit cards this could be as low as zero, i.e. the originating bank may be able to leverage the portfolio 100% essentially because of the combination of the speed of amortisation and the interest spread. More typically, the leverage would range up to a maximum of 95% for other asset classes and can be substantially lower.*
- *At this stage there are two layers of debt: one at the original individual borrower level and the other at the SPV level. In certain circumstances, there may be three layers of leverage, where the assets within the SPV are debt tranches in another CDO SPV.*
- *The SPV debt only has recourse to the underlying assets in the SPV. Accordingly the remedies are limited if the cash flow falls to a level that does not afford 100% debt service.*
- *The debt in the SPV is tranced ranging typically from senior (AAA) through progressive layers of subordination. The mix and structure is designed to reflect the market's risk appetite for the different tranches so as to minimise the cost of the overall borrowing to the originator.*
- *Unlike corporate debt, where the rating focus is on whether the corporate will default or not, the rating focus in structured finance is on determining the likely total level of defaults and losses on the pool of assets, i.e. will the level of losses impair the capacity to meet the debt service obligations on the different tranches of debt?*
- *One of the quoted advantages of structured finance over a corporate is that the purchaser of the paper has the benefit of risk diversification from the pooling of assets. The CRAs address this issue as part of their rating process.*
- *Concentration risk is the other side of risk diversification and is a fundamental issue in the rating of structured finance. This is the extent to which the assets are correlated, i.e. may default simultaneously. It arises because of some common risk factor; usually, it is viewed by many on a sectoral basis. However, risk concentrations can arise in different guises, e.g. the subprime residential mortgages were distinguished by the fact that the acknowledged primary source of re-payment was not the borrower cash-flow, but instead 'refinancing' which ultimately dried up as a source of repayment. This represented a concentration of risk that ultimately proved fundamental in the crisis that ensued.*
- *The 'waterfall' repayment arrangements, with priority based on seniority, determine the debt service coverage on the different tranches, which in turn helps determine the rating of each individual tranche.*

- *The rating of structured finance debt has been much more model-driven than corporate debt and has more systemised monitoring focused on monthly cash-flow and actual delinquency/default experience on the underlying assets. There is a substantial level of complexity in the rating of structured finance debt which requires a wide range of variables to be taken into account and incorporated in the model. The models should reflect the cumulative expertise of the analysts in a CRA and data history to the extent that it is available and adequate.*
- *The CRAs typically do not do any due diligence themselves on the underlying SPV assets. They rely typically on the assurances and due diligence work by the originators and sponsoring banks.*

Page 14, second and third paragraphs of Question 8: It may be that the strong macro perspective used in the rating of corporates, where the CRAs have a long record of credibility, was not considered in an equivalent manner in the rating of structured finance securities. The surveillance/review of structured finance securities appeared to have a heavy ‘micro’ focus on the monthly cash flow and delinquency experience as distinct from a broader strategic consideration of the big macro factors impacting the quality of the securities. Monthly cash flow and delinquency experience is essentially a lagging indicator rather than a leading indicator.

There is limited evidence available to suggest that consideration was given to the particular concentration risk inherent in a pool of subprime residential mortgages, i.e. the primary source of repayment was the ‘refinancing’ market which ultimately dried up and proved fundamental in influencing the scale of default/loss in the crisis that ensued. The CRA philosophy of ‘rating through the cycle’ may have encouraged a bias where non-cyclical deterioration was sometimes viewed as cyclical change, which would reverse over time. This may have been a contributory factor in the “misreading” of subprime, which resulted in a delayed recognition of fundamental deterioration and reflection thereof in the ratings.

* * *

The role of CRAs in structured finance (Points 90 to 96 of CESR's report)

90. CRAs play a significant role in capital markets, providing a key source of information on credit risk to investors. As a reminder, according to the definition included in the IOSCO Code of Conduct, a credit rating “is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system”. Therefore, according to this definition, CRAs ratings are opinions on creditworthiness but not on the price or liquidity characteristics.

91. Structured finance consists of the pooling of assets and the subsequent sale to investors of tranching claims on the cash-flows backed by these pools, usually through a Special Purpose Vehicle (SPV). Over the past 5 years, the issuance volume of structured finance products soared partly as a result of the search for alternatives in the context of the declining attractiveness of returns, but also driven by the incentive for banks to take loans off balance sheets. The volume of structured finance issues in Europe was estimated at EUR 480 billion in 2006, grew by 72% yoy (year on year: comparing the first half of 2007 with the first half of 2006) in the first half year 2007 and then declined by 40% yoy in the second half of 2007.

92. Two main characteristics of structured finance products are the pooling of assets and the tranching process which is designed to create seniority ordering among the different tranches of securities. Senior classes of securities are designed in order to be immune, to a certain extent, from default losses, which are initially borne by riskier (equity and mezzanine) tranches. This segmentation enables the product to appeal to investors with different risk profiles.

93. These characteristics however imply a high level of complexity, as the tranching process consists of legally organizing the distribution of cash-flows from the asset pool to different tranche investors. In order to adequately assess these instruments, an investor needs to gauge the credit risk of the underlying (heterogeneous) collateral assets but also to have sufficient insight into the legal structure and the specific provisions of the transaction (e.g., implication of asset managers) that organize the different seniority levels of the tranches.

94. Due to this complexity and the rising interest of larger categories of investors, which often do not have the resources, time or expertise for a thorough analysis of the risk of the available securities, the market has come to heavily rely on credit ratings. They form the easiest source of information and a standardized evaluation of structured finance transactions. In that sense, ratings help reduce the information asymmetry. Moreover, ratings, and particularly investment-grade ones, are also a requisite in order to market senior tranches to those asset managers with rating-based investment restrictions. However, ratings for structured finance products are designed purely to represent the likelihood of default and do not indicate market valuation and liquidity risk, meaning that risk assessment based purely on these ratings will not cover the full range of risks associated with these investments.

95. CRAs have thus developed and continue to adapt methodologies (model-based) to rate structured finance transactions, which grew to account for an increasingly significant part of their revenues and income. In 2007, despite the drop in activity in the second half-year, structured finance ratings still represented 40% to 50% of the CRAs' revenue. Fees as a percentage of the nominal value of the transaction are believed to be 2 to 3 times higher for structured finance than for traditional ratings.

96. The difference in the rating process may explain this variance in fee levels. Not only are the ratings more complex and time consuming due to their very nature but also the rating of structured finance transactions distinguishes itself from the rating of traditional instruments by the greater flexibility to adapt the features of the transaction in order to achieve the rating level desired for each tranche of the structure. As opposed to traditional ratings, the rating of a structured finance transaction is a target, not the outcome of the rating process. Therefore, CRAs have taken a more important and involved part in a deal's structuring process, with criticism from some quarters that their involvement is now actually advisory. Arrangers use CRAs' models to structure the deal and subsequently go through an iterative process with the CRA, with the ultimate goal for the issuer being to maximize the size of the tranche(s) with the highest rating or minimize the cost/quality of assets used to reach a high rating tranche or minimize the level of credit protection needed for a certain tranche. Compared to their initial role of a third-party monitor of credit default risk on the basis of pre-existing financial and economic conditions, CRAs seem to have taken a much more interactive role in the deal process when it comes to structured finance transactions.

References in footnotes

106. *The current crisis has again given rise to criticisms that CRAs were much too slow to react, as was alleged to be the case in previous corporate scandals. The delay in the downgrading process of structured finance securities backed by subprime mortgage assets raises questions on the efficiency of CRAs' methodologies, the robustness of their historical default models in a relatively new market and their rating surveillance procedures.*

...

136. *When rating agencies revise their methodologies for the rating of a particular asset class of structured finance they do not necessarily review all relevant existing rated securities against this methodology. The CRAs highlighted the fact that often these securities will be behaving as was expected at issuance and therefore reviewing these ratings against the new methodology would not be appropriate. Past-issuances would be reviewed against the new methodology if they were performing outside of expected parameters.*

137. *CESR found that whilst methodologies were freely available it proved difficult to track which evolution of the particular methodology had been used to rate/review specific issuances. This clearly could pose a problem to market participants trying to assess what value to place on a particular rating.*

...

225. *The four CRAs' codes comply to a large extent with the IOSCO Code. Some CRAs have implemented a couple of improvements in their respective code of conduct. There are, however, areas or provisions where the CRAs' codes do not comply. As well, CESR recognized a few areas of minor importance, where the CRAs do not formally mirror the IOSCO Code with their provisions but nevertheless reach the outcome the IOSCO Code aims at. However, CESR expected to see a more rigorous approach from CRAs in response to last year's report. Thus, CESR's expectations for improvement were only partially met by the CRAs.*

9.7. Individual initiatives of the CRAs

1. Standards and Poor's' (S&P's) reform plan

On 7 February 2008, S&P publicly announced a set of actions consisting of the following steps:

- Appointment of an Ombudsman to address concerns from issuers, investors, employees and other market participants regarding potential conflicts of interest and S&P's analytical and governance processes.
- Engagement of an independent firm to conduct periodic reviews of compliance and governance processes, the results of which will be publicly disclosed in a written opinion of the firm as to the independence of S&P's ratings.
- New policies to strengthen analyst independence and prevent long-standing relationships from inadvertently affecting ratings, such as by providing for five year client rotations for all analysts, assigning primary analysts to new structured finance transactions so that analysts are responsible for transactions managed by different arrangers and implementing “look back” reviews whenever an analyst leaves to work for an issuer.
- Additional identifier to the ratings of securitizations that will highlight to the market that the rating is on a securitization or a new type of instrument, with accompanying disclosure regarding the implications.
- Enhancing ratings' transparency by including “what if” scenarios to explain key rating assumptions and the potential impact of unexpected events, to help investors assess an issue's risk profile.
- Complementing ratings analysis by highlighting non-default risks that can influence the market performance of rated securities.
- Work with issuers and investors to improve disclosure of information on collateral supporting securities.
- Investor education through actions such as the publication of a Credit Ratings User Manual & Investor Guidelines, to promote better understanding of the ratings process and the role of ratings in the financial markets.

2. Steps taken by Moody's

Moody's put forward two individual initiatives in the CRA debate. The first set of measures by Moody's was presented in September 2007:

- Moody's would look for additional third party oversight that reviews the accuracy of the information provided by borrowers, appraisers and brokers to originators.
- Moody's would look for loan originators and issuers of non-prime mortgage backed securitizations requesting ratings from Moody's to provide investors stronger and more uniform representations and warranties that the loan information provided to investors is accurate and that the loans included in the transaction were appropriate for the borrowers.

- Prospectively, Moody's would look for services to provide monthly loan level performance information for all newly originated RMBS transactions. Moody's also recommended that for public transactions, loan level information both prior to closing and throughout the life of the transaction should be provided to all transaction participants requesting it.

In February 2008 Moody's published a consultation paper in which it invited user's views on differentiating the rating scales for structured finance products. In summary the options considered were:

- Move to a completely new rating scale for structured securities, for example, numerical rankings of 1-21. These would continue to contain ordinal rankings of expected credit risk and would probably map to corporate ratings.
- Add a modifier to all structured ratings utilizing the existing rating scale, e.g., Aaa.sf. This would designate the issue as structured, but add no other additional information.
- Add a suffix to the existing rating scale for structured ratings that contains additional information – for example, estimates of multi-notch rating transition risk. This could be Aaa.v1, Aaa.v2, etc. We would derive these gradations through an analytical process that would be disclosed to the market.
- Use the existing rating scale for structured securities, and put additional analytical information in a separate scale that would exist in a separate data field. For example, an issue could have an “Aaa rating, with a ratings change risk indicator of v1”. The added field would be analogous to our existing ratings outlooks and watch lists.
- Make no changes to the rating scale, but provide additional information and commentary through written research.

On 26 March 2008 Moody's published further proposals which aim to better address the issue of the quality of the data used in the rating. In particular, following discussions with market participants, Moody's proposed more specific enhancements to improve transparency, data integrity, and accountability:

- Stronger representations and warranties of the issuers with regard to how they address fraud, misrepresentation, data quality, early payment defaults and adherence to underwriting guidelines.
- Independent third-party pre-securitization review of underlying mortgage loans
- Standardized post-securitization forensic review
- Expanded loan-level data reporting of initial mortgage pool and ongoing loan performance
- More comprehensive originator assessments

These five enhancements are intended to work together to provide more standard and reliable information on residential mortgage-backed securities (RMBS) transactions than that currently available. Moody's ability to rate a particular RMBS or assign a high or investment grade rating will depend in part upon the degree to which issuers incorporate these enhancements.

3. Steps taken by Fitch

Fitch has separated its non-rating businesses into a separate division, Fitch Solutions. The CRA has implemented senior management changes in its structured finance operations and introduced a series of Group Credit Officers into the major rating groups to support objectivity and consistency in the rating review process. Fitch is working on further initiatives including increased analyst and manager rotation, enhancements to the formal internal training programs for analysts, greater external investor education efforts and is considering a broad range of feedback on other aspects of the current agency business model.

An operational review of major asset class criteria has led to revision of the CRA's approach to residential mortgage ratings in the US and to the ratings of collateralised debt obligations and market value products globally. Portfolio-wide stress-test analyses of CMBS transactions in the US and Europe have also been completed and published. Further work is underway to improve transparency of rating assumptions, including the publication of a series of additional "what-if" scenarios for major asset classes, the roll-out of additional electronic tools to communicate surveillance and cross-transaction comparisons for structured finance ratings, and the addition of Rating Outlooks at the tranche level across structured finance transactions in selected markets. The CRA also worked on the development of additional rating scales and indicators that will complement its opinions on structured finance

9.8. Detailed policy options

9.8.1. Policy options to remedy CRAs' insufficiencies in their internal organisation and controls in relation to conflicts of interest

The general policy in this regard is that CRAs have to ensure that existing and potential conflicts of interest will not affect ratings.

1. There should be some limitations for CRAs in order to avoid conflicts of interest.

Options:

- a) *General principle:* CRAs shall identify conflicts of interest and either eliminate or properly manage and disclose them.⁸⁸
- b) *Impose concrete limitations on CRAs activities:* CRAs shall not be entitled to issue a rating in situations that can impair their independence, for instance, when an agency's rating revenues from a single client go beyond a certain limit, or when the agency or its employees involved in the rating process have ownership interest in the rated entity⁸⁹.
- c) *Impose high internal governance standards:* CRAs shall have an independent review function accountable for periodically reviewing the methodologies, models and significant changes to methodologies and models it uses, as well as the appropriateness of those methods and methodologies for the assessment of new financial instruments. The primary reporting line of the head of this function shall be to a policy sub-committee of the administrative or supervisory board, composed exclusively of non-executive directors. At least 50% of the non-executive directors of each CRA shall have relevant expertise and experience in the risk business; their compensation should be essentially a fixed fee (i.e. they should not qualify for performance linked compensation, e.g. share options); they should have a fixed term of office.⁹⁰

2. To eliminate conflicts of interest in the provision of advisory services CRAs should avoid human or technical link between the rating and advisory activities.

Options:

- a) *Obligation to separate business:* A CRA shall separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses. It shall ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business are subject to procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise⁹¹.

⁸⁸ This general obligation is inspired in IOSCO code, provision 2.6.

⁸⁹ The US Act on CRAs of 2006 contains similar limitations.

⁹⁰ Recommendations B1 to B4 from ESME report.

⁹¹ Provision 2.5 of the IOSCO code. In this regard, CESR considers that a clearer consensus over what constitutes an advisory activity in the structured finance rating process would be beneficial to the

- b) *Separation with additional caveats*: an approach analogous to the one followed in Directive 2006/43/EC on statutory audits could be suggested⁹². Article 40 of this Directive provides for the publication of a transparency report by the auditor of public interest entities. CRAs could be required to publish a transparency report with relevant information. In addition, the provision of additional non-rating services may be prohibited in case this would threaten the agency's independence.
- c) *Limited prohibition*: CRAs shall not provide consulting or advisory services to issuers that they are rating.⁹³
- d) *Complete prohibition*: CRAs shall not provide any consulting or advisory services⁹⁴.

3. CRAs should ensure that the dialogue of the analysts with the rated entity remains unbiased and objective.

Options:

- a) *Clearly defined role of the analysts*: Analysts shall be prohibited from making proposals or recommendations regarding the creation or design of structured finance products.⁹⁵
- b) *Transparency*: CRAs shall ensure that they are fully transparent in terms of the exact nature of their interaction with issuers/arrangers of structured finance products. CRAs shall also ensure and demonstrate that they have strong policies and procedures in place to monitor and control this interaction and ensure it reflects their public position.⁹⁶
- c) *Record keeping*: In addition to the introduction of an express prohibition of active analyst's role in structuring the product, CRAs shall record the event and substance of the dialogue between the analyst and the issuer. Records could take the form of audit trails subject to independent review by a third party.⁹⁷

market as this would clarify market and regulatory expectations. Moreover, CESR supports the view that the IOSCO Code should provide greater clarity and act as a benchmark of acceptable practices for CRAs' interaction with issuers of structured finance products.

⁹² Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC. This Directive contains several requirements in this regard: Article 40 provides for the publication of a transparency report by the auditor of public interest entities. This report includes financial information on the firm turnover divided into fees from audit and non audit services; Article 25 establishes that the fees should not be influenced by the provision of additional services; Article 22 prohibits the provision of additional non-audit services if this threatens the auditor's independence at an unacceptable level.

⁹³ Recommendation B9 in the ESME report.

⁹⁴ Solution suggested by CRAs in the Joint White Paper.

⁹⁵ Provision 1.14-1 of IOSCO code, Recommendation B9 in ESME report and proposal from CRAs in the Joint White Paper.

⁹⁶ Paragraph 186 of CESR report.

⁹⁷ In accordance with the US Act on CRAs of 2006 the CRA is obliged to keep records of: a) internal records including non-public information and work papers used to form the basis of a credit rating – including notes of conversations with management of issuers; b) internal records used to form the basis

- d) *Additional safeguards of analysts' independence:* the analysts and any other employees directly involved in the credit rating process shall not be allowed to participate in discussions regarding fees or payments with any rated entity⁹⁸ The rating agencies should also envisage compulsory periodic rotation of analysts.⁹⁹

4. CRAs should avoid the negative impact of conflicts of interest in relation to the remuneration prospects and other economic incentives of persons involved in the rating process.

- a) *Reporting lines* for the rating staff and their compensation arrangements shall be structured to eliminate or effectively manage actual and potential conflicts of interest: in particular, analysts shall not be compensated or evaluated on the basis of the amount of revenue generated by the analyst.¹⁰⁰
- b) *Additional organisational requirements:* the agency shall ensure the independence of the analysts and persons approving the ratings in the design of the reporting and communication channels between them and the part of the agency responsible for the commercial interests of the entity;
- c) *Increase the fixed element of the salary for the top managers:* change the mix in compensation of the CRA top management towards a higher fixed salary component and substantially reduced performance related incentives.¹⁰¹

5. The "shopping for ratings" practice should be mitigated:

- a) *Disclosure to the market:* an agency shall disclose on a periodic basis a list of all cases where an issuer or arranger of a structured finance instrument provided the agency with information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (a) did not contract with the credit rating agency for a final rating, but contracted with another credit rating agency for a final rating of that same instrument; or (b) contracted with the credit rating agency for a final rating and did not publish the credit rating agency's final rating, but published the ratings of another credit rating agency for that same instrument.¹⁰²
- b) *Encourage issuers to disclose all necessary information:* CRAs shall in an industry effort exert pressure on structured finance issuers and arrangers of structured finance products to publicly disclose all relevant information regarding these products so that investors and other CRAs can conduct their own analyses independently of the CRA contracted by the issuers and/or originators to provide a rating. This would facilitate

for the opinions expressed in these reports, and c) external and internal communications that relate to initiating, determining, maintaining, changing or withdrawing a credit rating.

⁹⁸ Similar limitation could be found in US Act on CRAs of 2006 and in the provision 2.12 of IOSCO code.

⁹⁹ See recommendation B6 in ESME report. A similar requirement in article 42.2 of the Directive 2006/43/EC on statutory audits. Standards and Poor's announced in January 2008 that it would be implementing a system of rotation.

¹⁰⁰ Provision 2.11 of IOSCO code and CRAs Joint White Paper.

¹⁰¹ Recommendation E2 in ESME report.

¹⁰² Proposal discussed in the CRAs task force of IOSCO.

the appearance of unsolicited ratings which would help to avoid the "shopping for ratings" practice¹⁰³.

- c) *Clients should refrain from shopping for ratings:* issuers should not inquire several credit rating agencies for their preliminary rating assessment of the potential structured finance instrument before they finally decide on the credit rating to be published.

6. The independence of the analysts should be granted even when he/she joins a rated entity:

- a) *Cooling off period:* During a certain period after leaving the agency the analyst shall not be able to accept key management positions from the previously rated entity.¹⁰⁴
- b) *Look back reviews:* The agency shall review the past work of an analyst in the event that he or she leaves the agency to work for a client that he or she has rated.¹⁰⁵

9.8.2. *Policy options for improving the quality of rating methodologies and the ratings*

1. Methodologies, models and key rating assumptions should be appropriate and up to date for the rated instruments.

Options:

- a) *CRA's shall put in place an independent review function:* CRA's should establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models it uses, as well as the appropriateness of those methodologies and models for the assessment of new instruments. Where feasible and appropriate for the size and scope of its credit rating services, this function should be independent from the business lines that are principally responsible for rating various classes of issuers and obligations.¹⁰⁶
- b) *CRA's shall review their methodologies in case of significant changes:* CRA's shall assess whether existing methodologies and models for issuing credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially.¹⁰⁷ In addition CRA's shall review all their methodologies on a regular basis, e.g. once a year.
- c) *Methodologies and models should be validated by a public authority:* to ensure that the methodologies and models used by an agency are appropriate and up to date, such methodologies, models and assumptions shall be validated and periodically

¹⁰³ Provision 2.8.c of IOSCO code.

¹⁰⁴ Similar solution in the Article 42.3 of the Statutory Audits Directive 2006/43/EC: "*The statutory auditor or the key audit partner who carries out a statutory audit on behalf of an audit firm shall not be allowed to take up a key management position in the audited entity before a period of at least two years has elapsed since he or she resigned as a statutory auditor or key audit partner from the audit engagement*".

¹⁰⁵ Provision 2.17 of IOSCO code, recommendation in Q11 of ESME report, CRA's Joint White Paper.

¹⁰⁶ Provision 1.7-2 of IOSCO Code.

¹⁰⁷ Provision 1.7-3 of IOSCO code.

reviewed by the securities supervisor of the Member State where the agency operates, at the request of the agency.

2. CRAs should diligently monitor the existing ratings.

Options:

- a) Require CRAs to have – when feasible – separate teams for the initial rating and the ongoing surveillance of structured finance transactions¹⁰⁸. If a CRA uses separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, each team should have the appropriate level of expertise and resources to perform their respective functions in a timely manner.¹⁰⁹
- b) Require CRAs to regularly monitor and update ratings: A CRA shall ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings. Once a rating is published the CRA shall monitor on an ongoing basis and update the rating by: a) regularly reviewing the issuer’s creditworthiness; b) initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology; and, c) updating on a timely basis the rating, as appropriate, based on the results of such review.¹¹⁰
- c) Envisage expiry of rating after a certain period: In addition to the obligation to review the rating on a regular basis, the CRA is required to update the ratings at least once in a specified time period (e.g. one year).

3. CRAs should apply changes in methodology consistently to all ratings concerned.

Options:

- a) *Impose disclosure obligation:* CRAs shall disclose whether they apply retroactively model changes to existing ratings.¹¹¹
- b) *Re-rate regularly:* Require CRAs to apply the changes to past ratings due to the new methodology in the course of the regular review cycle of ratings. After a change in methodology CRAs shall update the ratings in a timely manner using the new methodology. CRAs shall be transparent as to which methodology has been used for a current rating. CRAs should apply the changes in ratings criteria and assumptions where appropriate to both initial ratings and subsequent ratings.¹¹²
- c) *Require CRAs to promptly re-rate existing ratings according to new methodology:* Whenever a rating methodology changes, CRA shall have to immediately disclose the likely scope of ratings that will be affected. After the change in methodology the CRAs have to re-rate all the ratings that have been based on these methodologies.

¹⁰⁸ CRAs proposal from the Joint White Paper.

¹⁰⁹ Provision 1.9-1 of IOSCO code.

¹¹⁰ Provision 1.9 of IOSCO code.

¹¹¹ Approach of US Act on CRAs of 2006.

¹¹² Provision 1.9 of IOSCO code.

4. CRAs should use sound information for the issuance of ratings.

Options:

- a) *General obligation of ensuring good quality of information:* A CRA shall make sure that the information it uses in assigning a rating is of sufficient quality to support a credible rating.¹¹³
- b) *CRAs or a suitable third party shall undertake due diligence of information:* CRAs shall have the responsibility to ensure that the information which underpins their ratings is statistically sound. This requires independent and robust due diligence to be undertaken. The CRAs shall carry out this due diligence themselves (if disposing of the necessary competence) or delegate it to a suitable third party like for instance a recognised accounting firm or, if appropriate, the sponsoring bank.¹¹⁴
- c) *Quality warranties:* CRA shall require underwriters to provide representations about the level and scope of due diligence that they have performed on the underlying assets.¹¹⁵ An agency shall clearly indicate the limits to which it verifies information provided to it by the issuer or originator of a rated security.¹¹⁶
- d) *Abstention from issuing ratings if no sound data:* If a CRA cannot obtain sound data or is not able to verify the data either itself or relying on a suitable third party, it shall refrain from issuing a credit rating or withdraw an existing rating.¹¹⁷ In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security, CRA should refrain from issuing a credit rating.¹¹⁸
- e) *Warning if data limited or statistics sound:* If the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the CRA shall make clear, in a prominent place, the limitations of the rating.¹¹⁹ If an agency cannot obtain sound data or is not able to verify the data either itself or

¹¹³ Provision 1.7 of IOSCO code.

¹¹⁴ ESME considers that it is essential that CRAs accept that they have the responsibility to ensure comfort is given to investors on the integrity of the information which underpins their ratings, taking into account the crisis of confidence in ratings and the collapse in the volume of new structured finance issues. This would require independent and robust due diligence to be undertaken. In this regard the CRAs could either: a) Obtain assurances from the sponsoring bank that it has undertaken appropriate due diligence, in circumstances where the sponsoring bank is deemed credible and capable of honouring their obligations under their indemnities; or b) Commission a suitable external party, e.g. one of the internationally recognised accounting firms, to undertake the due diligence, or c) Undertake the due diligence themselves. (Recommendation B7 in ESME report).

¹¹⁵ First and second indents of the recommendation IV.6 of the Financial Stability Forum report.

¹¹⁶ Provision 3.5.c of IOSCO code.

¹¹⁷ Fourth indent of the recommendation IV.6 of the Financial Stability Forum report.

¹¹⁸ Provision 1.7-3 of IOSCO code.

¹¹⁹ Provision 1.7 of IOSCO code.

relying on a suitable third party, it shall disclose the limitations of the rating to the users.¹²⁰

5. CRAs shall allocate adequate staff to the rating process.

Options:

- a) *General obligation of employing appropriate staff:* CRAs shall ensure that employees directly involved in the rating process have appropriate knowledge and experience for the duties assigned. In particular, the CRA shall ensure that its monitoring function is adequately staffed.¹²¹
- b) *Additional transparency requirement with respect to the employees:* CRAs shall disclose staff numbers and qualifications as allocated to the different functions of the rating agency¹²². CRAs have to keep record of the identity of any credit analysts that participated in the determination of any credit rating.
- c) *Require a formal qualification for rating analysts:* A specific professional qualification shall be developed for rating analysts defining a minimum level of knowledge and experience that credit analysts shall have. CRA shall rely on this qualification in order to employ suitable rating analysts.¹²³

6. The analysis of an issuer or a product by the agency should take into account the impact of market developments and macro economic expectations.

Options:

- a) *CRAs shall provide sufficient information about loss and cash-flow analysis related to the structured finance instrument:* Where a CRA rates a structured finance product, it shall provide investors with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating. A CRA shall also disclose the degree to which it analyses how sensitive a rating of a structured finance product is to changes in the CRA's underlying rating assumptions.¹²⁴
- b) *CRAs shall expand the initial and ongoing information that they provide on the risks characteristics of structured products:* CRAs shall include additional initial and ongoing information on rating stability, the assumptions underlying a structured product rating and the sensitivity of the rating to changes in these assumptions.¹²⁵ They shall expand the information they give on *model assumptions and stress testing*. CRAs shall provide information on critical model assumptions, in

¹²⁰ Provision 3.5.c of IOSCO code.

¹²¹ Provision 1.9 of IOSCO code.

¹²² A similar approach is followed in the US Act on CRAs of 2006.

¹²³ Inspired in Statutory Audits Directive 2006/43/EC.

¹²⁴ Provision 3.5.a of IOSCO code.

¹²⁵ Recommendation IV.5 in the Financial Stability Forum Report of April 2008.

particular, the weightings of key parameters and correlations underlying structured finance ratings.¹²⁶

- c) *Public authorities shall validate the models and assumptions applied by CRAs:* to ensure that the models and assumptions used by an agency include the information referred above, such methodologies, models and assumptions shall be subject to prior validation by the securities supervisor of the Member State where the agency operates, at the request of the agency.

9.8.3. *Policy options in relation to transparency of the CRAs*

A number of options may be considered in order to trigger improvements in the CRAs' transparency (as regards their internal policies, their performance and the presentation of the ratings).

In particular, the following specific objectives should be fulfilled:

1. The agency has to be transparent with respect to the functioning of internal processes and procedures.

Options:

- a) *General transparency obligation:* CRAs shall publish sufficient information about its procedures, methodologies, models and assumptions so that outside parties can understand how a CRA arrived at a rating. CRAs shall provide investors/subscribers with the necessary information to understand the basis for the CRA's rating, including sufficient information about the internal code of conduct of the agency, methodologies and historic performance data.¹²⁷
- b) *Require CRAs to disclose a periodic report:* CRAs shall be required to publish periodically a transparency report containing information such as legal structure and ownership of the agency, description of the internal quality control system, indicators on staff allocation, description of credit ratings record-keeping policy, outcome of internal review of independence compliance, financial information on the agency's revenue, description of management and key analysts rotation policy and a corporate governance statement.¹²⁸

2. The information included in the ratings has to be relevant and sufficient in order to efficiently assess the probability of default of an instrument.

¹²⁶ This information should include an economic explanation for the assumptions in order to allow investors to fully understand the structured finance ratings and thus to make better use of them in their investment decisions. Information on the level of stress testing carried out during the rating process, to address concerns over tail risks would also provide investors with the information needed for them to judge the impact of economic events or market disruption on the volatility of the ratings (Paragraph 134 of CESR report).

¹²⁷ Provisions 3.5 and 4.3 of IOSCO code.

¹²⁸ This option is inspired in the Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, article 40. There are similar requirements of disclosure for the registration of a NRSRO in accordance to US Act on CRAs. The agencies have to update this information annually in case there is any material change.

Options:

- a) *Obligation to provide information on loss and cash-flow analysis and about sensitiveness to changes in rating assumptions:* Where a CRA rates a structured finance product it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor can understand the basis for the CRA's rating. A CRA should also disclose the degree to which it analyses how sensitive a rating of a structured finance product is to changes in the CRA's underlying rating assumptions.¹²⁹
- b) *CRA's to be more engaged in investors' education:* CRAs shall clearly explain attributes and limitations of credit rating opinions and focus their efforts on communicating better and educating rating users as necessary.¹³⁰
- c) *Require additional technical information in the ratings:* CRAs shall share information on the key assumptions, including, e.g. 'expected loss' with disclosure also of historic 'worst case/best case scenarios' and 'break-even' credit loss for different tranches. They should include 'what if' scenario analysis to convey an understanding of the sensitivity of the rating to adverse or positive events.¹³¹

3. Avoid investors' confusion triggered by the use of the same symbols for the ratings for structured products and the ratings for traditional debt (corporate, sovereign).

Options:

- a) *Use different symbols for traditional ratings and structured finance ratings:* A CRA shall differentiate ratings of structured finance products from traditional corporate bond ratings, either by introduction of a different rating scale or with additional symbols. A CRA shall also disclose how this differentiation functions.¹³² Instead of using different symbols the agency may disclose the differences between ratings of structured products and other securities¹³³
- b) *Use the same scale but aggregate additional information to the ratings:* CRAs shall inform users of the greater potential volatility associated with structured finance instruments and the reasons for it. A label/rating suffix to measure and communicate the inherent volatility may be introduced, i.e. the likelihood of rapid and large rating transition.¹³⁴

¹²⁹ Provision 3.5.a of IOSCO code.

¹³⁰ For example, user manuals may be needed to assist different investor groups in their use of ratings, due to widely varying levels of technical capacity to understand the rating complexities (recommendation C9 in ESME report).

¹³¹ Recommendations C1 and C2 in ESME report.

¹³² Provision 3.5.b of IOSCO code and Recommendation IV.2 of the Financial Stability Forum report of April 2008.

¹³³ SEC proposal to implement the US Act on CRAs announced on 11 June 2008.

¹³⁴ Recommendation C6 of ESME report.

- c) *Educate investors in the particularities of the ratings for different products:* CRAs shall clearly indicate attributes and limitations of credit rating opinions.¹³⁵

4. CRAs should make available to market participants the relevant data about their performance in a standardised manner to allow for industry-wide comparisons.

Options:

- a) *Initiative of the CRA industry:* CRAs shall establish a centralized repository for ratings performance studies to allow easier market comparisons among the CRAs and make available ratings performance data to regulatory authorities, upon request, to allow regulatory authorities to conduct their own studies of ratings performance.¹³⁶
- b) *Obligation to publish historical default rates:* CRAs shall publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time. If the nature of the rating or other circumstances makes a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, CRAs shall explain this. This information shall include verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.¹³⁷
- c) *Impose on CRAs the obligation to disclose standardised performance information and create a repository of ratings at EU level:* CRAs shall disclose information on their performance to a central repository that could be created and managed by CESR, with the assistance of the CRAs. CESR shall issue guidance on common standards on the historical performance data that CRAs would have to disclose.

9.9. CRAs joint proposals in the White Paper. Summary

In October 2007, a group of CRAs including A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc.; Moody's Investors Service, Inc.; and Standard & Poor's Ratings Services began working together to suggest measures to enhance confidence in the credit rating process, particularly with respect to structured finance securities. They have communicated their views on those subjects to regulators and legislators, by circulating a discussion paper in December 2007 in which the participating CRAs made certain proposals regarding enhancing the independence, quality and transparency of credit ratings.

The main content of this discussion paper is as follows:

¹³⁵ CRAs Joint White Paper.

¹³⁶ CRAs Joint White Paper. ESME recommends that the major CRAs, with input from IOSCO and other relevant market sources, should agree a set of measurement principles and framework which would become the market norm for evaluating the performance and success of rating agencies. ESME suggested that the framework should incorporate, inter alia, 'rating accuracy', the incidence of downgrades relative to a benchmark 'norm' and the average downgrade in terms of number of notches moved (Recommendation D.1 in ESME report).

¹³⁷ Provision 3.8 of IOSCO code.

Independence of the credit rating process

- CRAs should explicitly forbid credit rating analysts from making proposals or recommendations regarding the creation or design of securitization products.
- CRAs should not provide consulting or advisory services.
- CRAs should conduct "look-back" reviews, as appropriate, when analysts leave CRAs to work for issuers or advisers with whom they have regularly interacted.
- CRAs should conduct formal, periodic, internal reviews of remuneration policies and practices for analysts and other CRA employees who participate in rating committees to ensure that these policies and practices do not compromise analyst objectivity.

Quality of credit ratings

- CRAs should conduct formal, periodic, internal reviews of rating criteria and methodologies to promote ratings quality.
- CRAs should establish separate teams for initial credit ratings and ongoing surveillance of structured finance transactions, whenever feasible.
- CRAs should require analysts to participate in continuing education programs on credit analysis, methodologies and CRA policies and procedures.
- CRAs should encourage greater market understanding of securitization products by supporting full disclosure by issuers to the market of the information needed to make informed investment decisions about structured finance transactions.

Transparency of credit ratings

- CRAs should help to establish a centralized repository for ratings performance studies to allow easier market comparisons among the CRAs.
- CRAs should make available ratings performance data to regulatory authorities, upon request, to allow regulatory authorities to conduct their own studies of ratings performance.
- CRAs should clearly indicate attributes and limitations of credit rating opinions.
- CRAs should play an active role in raising awareness among investors and other market participants about the meaning and intended purpose of credit rating opinions, the credit rating process and the CRAs' role in financial markets.

9.10. Information on asset write-downs and credit losses since the beginning of 2007 till mid May 2008.

(Source: Bloomberg)

The following table shows that there has been \$379 billion in asset write downs and credit losses since the beginning of 2007, including reserves set aside for bad loans, at more than 100 of the world's biggest banks and securities firms.

The write-down column includes asset-value reductions that some banks list on their balance sheets rather than booking the losses against earnings. Regulatory filings show \$35 billion of such balance-sheet write downs at 20 banks.

All the charges stem from the collapse of the U.S. subprime- mortgage market. The figures, from company statements and filings, also reflect some credit losses or write downs of mortgage assets that aren't subprime, as well as charges taken on leveraged-loan commitments.

All numbers are in billions of U.S. dollars. They are net of financial hedges the firms used to mitigate losses.

Firm	Write-down	Credit Loss	Total
Citigroup	37.3	5.6	42.9
UBS	38.2		38.2
Merrill Lynch	37		37
HSBC	6.9	12.6	19.5
IKB Deutsche	16		16
Royal Bank of Scotland	15.2		15.2
Bank of America	9.2	5.7	14.9
Morgan Stanley	12.6		12.6
JPMorgan Chase	5.5	4.2	9.7
Credit Suisse	9.5		9.5
Washington Mutual	1.1	8	9.1
Credit Agricole	8.3		8.3
Deutsche Bank	7.7		7.7

Wachovia	4.6	2.4	7
HBOS	6.9		6.9
Bayerische Landesbank	6.7		6.7
Fortis	6.6		6.6
Societe Generale	6.3		6.3
Mizuho Financial Group	6.2		6.2
ING Groep	6		6
Barclays	5.2		5.2
WestLB	4.8		4.8
Canadian Imperial (CIBC)	4.2		4.2
LB Baden-Wuerttemberg	4		4
E*Trade	2.5	0.9	3.4
Dresdner	3.4		3.4
Natixis	3.4		3.4
Wells Fargo	0.6	2.7	3.3
Lehman Brothers	3.3		3.3
Bear Stearns	3.2		3.2
National City	0.5	2.6	3.1
Goldman Sachs	3		3
BNP Paribas	2.1	0.6	2.7
Lloyds TSB	2.7		2.7
Nomura Holdings	2.5		2.5
HSH Nordbank	2.5		2.5
ABN Amro	2.4		2.4

Bank of China	2		2
Commerzbank	1.9		1.9
Royal Bank of Canada	1.7		1.7
UniCredit	1.6		1.6
DZ Bank	1.5		1.5
Alliance & Leicester	1.4		1.4
Dexia	1.1	0.2	1.3
Caisse d'Epargne	1.2		1.2
Hypo Real Estate	1		1
Gulf International	1		1
European banks not listed above (a)	9.2		9.2
Asian banks not listed above (b)	7.5	0.3	7.8
North American banks not listed above (c)	3	1.1	4.1
TOTALS*	332.3	46.9 (d)	379.2

* Totals reflect figures before rounding. Some company names have been abbreviated for space.

(a) The following European banks have experienced losses of less than \$1 billion each: Allied Irish Banks, Bradford & Bingley, Aareal Bank, Deutsche Postbank, Standard Chartered, Northern Rock, NordLB, Rabobank, HVB Group, Sachsen LB, Intesa Sanpaolo, Landesbank Hessen-Thuringen, SEB AB, Erste Bank, DnB NOR, Anglo Irish, KBC Group, LB Berlin, NIBC Holding.

(b) Asian banks with write downs of less than \$1 billion: Mitsubishi UFJ, Shinsei, Sumitomo Trust, Aozora Bank, DBS Group, Australia & New Zealand Banking Group, Abu Dhabi Commercial, Bank Hapoalim, Arab Banking Corp., Fubon Financial, Industrial & Commercial Bank of China, Citic International, BOC Hong Kong, Bank of East Asia, China Construction Bank, Sumitomo Mitsui, ICICI Bank, State Bank of India, United Overseas, Wing Lung.

(c) North American banks included in this group: Bank of Montreal, National Bank of Canada, Bank of Nova Scotia, BB&T Corp., PNC Financial Services Group, SunTrust Banks, South Financial Group, Sovereign Bancorp, First Horizon.

9.11. Data on issuance of structured finance products

European and US issuance of SF instruments (Euro, billions), from 2000 to first quarter 2008

(Source: ESF Securitisation Data Report Q1:2008, p. 2)

Year	EU	US
2000	78,2	1086,0
2001	152,6	2308,4
2002	157,7	2592,7
2003	217,3	2914,5
2004	243,5	1956,6
2005	327,0	2650,6
2006	481,0	2455,8
2007	453,7	2404,9
2008	40,0	285,2

The figures clearly show how the trend of issuance of structured products falls sharply in the first quarter of 2008, both in the EU and in US. The figures below show that this trend started in the second half of 2007 and how it evolved till the first quarter of 2008.

European and US issuance of SF instruments (Euro, billions)

2007 and 1st quarter 2008

	2007:Q1	2007:Q2	2007:Q3	2007:Q4	2008:Q1
EU	128,7	152	98,2	74,7	40
US	747,5	811,5	481,6	364,3	285,2

9.12. Comparative table with the Commission proposal, US rules and IOSCO code

EU Proposal	US rules/proposal	IOSCO Code	Other / Comment
<i>Organisational, corporate requirements</i>			
Requirement for registration	In line with SEC rules	Not required. The code is applied on a voluntary basis (Comply or explain principle)	
Supervision by the competent authority	In line with SEC rules. CRAs (NRSRO are supervised by the US SEC)	Not envisaged	
Reporting lines and the compensation of the persons involved in the rating process to be <u>separated</u> from the business end of the CRA.	Not envisaged.	A general rule in the IOSCO Code (reporting lines for CRA employees and their compensation should be structured to eliminate or effectively manage actual/potential conflicts of interest).	Envisaged in the ESME report. EU measure would make the IOSCO principle more concrete.
Internal functions to: (i) develop the CRA rating policy, monitor compliance with internal procedures and processes for the rating activity, and review the feasibility of providing ratings for new instruments; (ii) review the methodologies, models and significant changes to methodologies and models. This function should be independent of the rating activities.	Not envisaged.	Broadly in line with IOSCO Code.	
A special function on rating policy for some members the board to monitor development of the rating policy, effectiveness of the rating	Not envisaged.	Not envisaged.	Envisaged in the ESME report. A board committee, as the primary reporting line of the internal

internal quality systems, compliance and governance processes.			functions mentioned above, would increase profile of their activities and independence of these functions.
Whistle-blowing mechanism for anonymous reporting of irregularities by staff.		In line with the IOSCO Code.	A necessary tool for strengthening internal controls. Already a standard in most organisations.

<i>Conflicts of interest</i>			
General policy: CRAs to ensure that conflicts of interest (existing, potential) will not affect ratings. Conflicts of interest to be: (i) identified and either (ii.1) eliminated or (ii.2) properly managed and disclosed.	In line with the SEC rules.	In line with the IOSCO Code.	In line with EU approach in other areas (MiFID).
Disclosure when: 5% or more revenue from 1 entity	Stricter in the SEC rules (prohibition if more than 10%).	Broadly in line with the IOSCO Code (disclosure of more than 10%).	
Prohibition of offering / continuing rating when: 1) analyst or person approving ratings has direct ownership in the rated entity, 2) analyst or person approving ratings is a member of supervisory or management board of the rated entity 3) CRA associated with the rated entity	In line with the SEC rules.	In line with the IOSCO Code.	
Provision of consulting/advisory prohibited.	Broadly in line with the SEC rules.	In line with the IOSCO Code.	
Rating staff prohibited to	In line with the SEC	In line with the	

engage in fee negotiations.	rules.	IOSCO Code.	
<p>Rules on rating staff conduct:</p> <ul style="list-style-type: none"> - prohibition to engage in any transactions in instruments related to the rated entity, - handling confidential information (incl. unpublished ratings), - no gifts from the rated entity, - look-back reviews of ratings after an analyst has left to work for the rated entity. 	In line with the SEC rules (look-back reviews not explicitly mandated by the SEC).	In line with the IOSCO Code.	Look-back reviews, introduced by the revised IOSCO code, are an important tool to detect any irregularities on the part of analysts leaving the CRA to join a client.
<p>Rules excluding employees from the rating process. (triggered by conflicts of interest arising from owning financial instruments, recent employment, business or other relationship)</p>	In line with the SEC rules.	In line with the IOSCO Code.	
<p>Rules on rotation of analysts and other persons approving credit ratings. Max. 4 years on the same client, cooling-off 2 years minimum.</p>	Not envisaged.	Not envisaged.	Envisaged in the ESME report. Rotation requirement follows the solution in the auditing profession.

<i>Quality of ratings</i>			
<p>General policy: CRAs to use methodologies that are rigorous, systematic, continuous, and may be validated based on historical experience. Applied consistently by analysts. CRAs to ensure that methodologies, models and key ratings assumptions are up-to-date and subject to comprehensive review.</p>	Broadly in line with the SEC rules.	In line with the IOSCO Code.	
<p>Duty to re-rate: CRAs to re-rate all ratings following</p>	Broadly in line with the SEC rules. SEC	In line with the IOSCO Code:	The duty to re-rate is consistent with the

changes in methodologies, models, assumptions.	rules focus on disclosure of CRA's practice (CRAs to disclose if they apply retroactively model changes to existing ratings).	CRAs to update ratings on a timely basis and to keep them consistent with applicable methodology.	IOSCO approach and only makes it more concrete.
Monitoring activity: CRAs should monitor and update the rating on an on-going basis.	Broadly in line with the SEC rules. SEC rules focus on disclosure of CRA's practice (duty to disclose monitoring frequency).	In line with the IOSCO Code.	The duty to monitor ratings is consistent with the IOSCO approach. SEC-like disclosure is also required.
Limits to rating activity: CRAs not to issue ratings / withdraw existing rating when (i) lack of robust data; (ii) a new structure which raises serious doubts re. ability to assess creditworthiness.	Broadly in line with the SEC rules. SEC rules apply to structured finance ratings.	Broadly in line with the IOSCO Code. IOSCO rules apply to structured finance ratings.	It is necessary to extend the prohibition to rate when information insufficient also beyond the structured finance products.

<i>Communication with the markets</i>			
General rule: if ratings are intended for distribution channels or for the public, any rating decision should be disclosed on a non-selective basis and in a timely manner.	Broadly in line with the SEC rules.	Broadly in line with the IOSCO Code.	Approach consistent with US and IOSCO approaches. It also covers situations where ratings are not provided to the public free of charge (subscriber-pays model).
Different rating categories (symbols) for structured and traditional debt (either using different symbols or attaching each time a report on the differences between a structured and traditional rating).	In line with the SEC rules.	In line with the IOSCO Code (IOSCO indicates different symbols as the preferred way to differentiate between structured and traditional rating).	

<i>Record keeping obligations</i>			
Internal records support rating opinions to be kept for at least 5 years (incl.	Broadly in line with the SEC rules (3 years).	In line with the IOSCO Code.	

records of analysts' dialogue with the rated entity).			
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<i>Other malpractice</i>			
Prohibition of the notching practice (discriminatory treatment of ratings issued by other CRAs in situations where they could be used in the CRA's rating process)	In line with the SEC rules.	Not envisaged.	Such prohibition – following the US example – is crucial to eliminate the described anticompetitive practice of the main CRAs.

EU Measure	US measure	IOSCO	Other / Comment
<i>Disclosures and transparency</i>			
<p>Continuous disclosures</p> <p>The following disclosures would be required on a continuous basis:</p> <p>Methodologies, models and key assumptions in use. Any material modifications to methodologies and key assumptions.</p> <p>Potential and existing conflicts of interest.</p> <p>Definition of an ancillary service.</p> <p>General nature of compensation arrangements</p> <p>Information about rating staff numbers and allocation to different functions</p> <p>Other internal policies, significant for users of ratings e.g. policy on distribution of ratings.</p>	Broadly in line with the SEC rules.	In line with the IOSCO Code.	

Annual transparency report

<p>Agencies to produce a yearly report (publicly available) outlining its organisational arrangements, policies and practices with regard to rating activity and its quality and compliance aspects. Such report could describe:</p> <p>Legal structure and ownership (incl. significant direct and indirect shareholdings)</p> <p>Description of the internal quality system</p> <p>Information about rating staff numbers and allocation to different functions</p> <p>Description of record keeping policy</p> <p>Outcome of the annual internal review of independence compliance</p> <p>Financial information on revenue from rating fees and non-rating revenue.</p> <p>Management and analyst rotation policy.</p>	<p>Broadly in line with the SEC rules. While the reporting requirements imposed by the SEC may have a different scope (greater reliance on maintaining records facilitated to SEC inspectors), the transparency principle and the character of information provided to the markets is substantially similar.</p>	<p>Broadly in line with the IOSCO Code.</p> <p>The transparency report is not envisaged by IOSCO Code, but most of the disclosures that would be included in the transparency report may be required by IOSCO on an on-going basis.</p>	<p>The report would be useful for supervisory purposes and could also be referred to by users of ratings.</p>
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<i>Other periodic disclosures</i>			
<p>Historical performance data (default and transition studies) to be put in a central repository managed by CESR.</p>	<p>Envisaged as disclosure on website. (1, 3, 10 year horizon required for each rating category). Methods used for calculation to be publicly explained.</p>	<p>Envisaged.</p>	

<i>Standards for presentation of ratings</i>
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<p>CRA should ensure that the rating reports respect some basic standards for presentation of ratings. The elements to consider:</p> <p>Name and job title of analyst</p> <p>All substantial sources and whether CRA discussed draft rating with the rated entity</p> <p>Methodology. methodology version, any deviations explained</p> <p>Rating meaning, definition or default and recovery, risk warnings (sensitivity analysis and what-if scenarios). Best case and worst case ratings.</p> <p>Limitations of the rating including the CRA's statement whether it is satisfied with the information quality and if it verified the information in any way</p> <p>Whether rating was unsolicited</p> <p>For structured finance ratings, information about any loss and cash-flow analysis performed</p> <p>For structured finance ratings, CRA's statement if it has sufficient knowledge of due diligence processes at the underlying assets level (and outcome of any analysis performed).</p>	<p>Broadly in line with the SEC rules. Other major elements like methodology (-ies) in use, monitoring frequency, what information is used to establish ratings for structured products, and how CRA relies on due diligence by 3rd parties to verify asset quality are disclosed on a general basis (not with regard to specific ratings).</p>	<p>Broadly in line with the IOSCO Code.</p> <p>The standards for presentation of ratings have not been envisaged by IOSCO Code, but most of the disclosures that would be included in the rating report are anyway required by IOSCO.</p>	<p>The alignment of standards for presentation will benefit users of ratings, who will be furnished with higher quality material (in terms of transparency and accuracy) for their analysis. It is worth noting that similar standards have been set for investment recommendations in the Market Abuse Directive.</p>
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