



**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



EXECUTIVE SUMMARY

Background

1. In May 2007, CESR received a letter from the European Commission asking CESR to monitor the voluntary compliance of credit rating agencies (CRAs) with the IOSCO Code of Conduct Fundamental and to prepare a second report on the topic. The first annual report had been published in December 2006. In September 2007 the EU Commission issued a request for CESR to expand this report to review the role of CRAs in structured finance and re-evaluate regulatory options in this area.
2. To this end CESR issued a public consultation in February 2008 and held an open hearing on 26 March. This consultation gathered market views on the transparency of the rating process and rating methodologies, CRA staff resourcing, the monitoring of rating performance and the management of conflicts of interest in the ratings process. The paper also sought market views on whether further formal regulatory oversight should be introduced within the EU.

Areas Covered

3. This report includes in section II an **update on the various work streams and reports in relation to CRAs** that have been initiated since the last CESR report published in December 2006. This section provides a brief summary of the main initiatives that have been going on in the international market in relation to CRAs and, more specifically, those referred to the role of CRAs in the structured finance sector.
4. Section III of the report contains an **analysis of the rating process with regard to structured finance instruments**. In this section, CESR has analysed each of the areas requested by the European Commission and has provided a summary of the responses received from market participants. In addition, CESR has set out its views on the issues raised and has included clear recommendations to the European Commission. Before coming to its final recommendations, summarised below, CESR has analysed in detail the responses received to its consultation paper and has given due consideration to all the arguments put forward by market participants:
 - **Transparency:** CESR highlights the need for CRAs to take appropriate action on an ongoing basis to ensure that they communicate clearly regarding the characteristics and limitation of the ratings of structured finance products. CESR also believes further information should be provided on critical model assumptions to facilitate a greater understanding by market participants and that ratings should clearly label which methodology and version has been used. Where possible, CESR advocates that this information and information on rating performance should be provided in a standardised, publicly available format to support market participants in reaching their investment decisions.
 - **Human Resources:** CESR urges CRAs to effectively resource themselves to ensure their ratings are, and remain, of a sufficient quality. CESR expects that CRAs improve the disclosure of selective human resources indicators to promote confidence that they are appropriately resourced and to ensure that remuneration structures are appropriate to promote independence and avoid conflicts of interest in the rating process.
 - **Monitoring of Ratings:** CESR stresses the need for CRAs to effectively resource themselves to ensure that their monitoring remains effective and that rating action is taken in a timely manner.
 - **Conflicts of Interest:** CESR acknowledges that a clearer international consensus over acceptable interaction between CRAs and issuers, what constitutes advisory practice and a definition of what constitutes ancillary business would be of benefit to the market. CESR also stresses the need for CRAs to be transparent in the disclosure of the fees they receive from issuers.



5. Section IV of the report contains an **analysis of the changes in the CRA's codes of conduct**. It builds on the work included in CESR's last report and contains, in a columnar format, an analysis of the changes on those provisions of the CRAs' codes that CESR identified last year as areas of non-compliance with the IOSCO Code.
6. Finally, Section V of the report provides **CESR's conclusive considerations**. The initial part of the section contains an analysis and assessment of the changes under way: IOSCO's proposal to modify the Code and the CRAs' joint initiative. The second part of this section includes a summary of the responses received from market participants in relation to the questions on possible policy options and a description of CESR's policy proposal as summarised below.

Conclusion: CESR's policy proposal

7. CESR and market participants believe that there is no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings of US subprime backed securities and hence continues to support market driven improvement. Despite this conclusion CESR recognises that there needs to be a much greater involvement from market participants including issuers and investors as well as the CRAs themselves to ensure improvement and discipline. Also CESR recognizes that the use of ratings in the regulatory and supervisory framework, such as the ECAI in the CRD, could induce uncritical reliance on ratings as a substitute for independent evaluation.
8. CESR considers the IOSCO Code to be the standard on which CRA conduct of business should be assessed and believes that the IOSCO Code, including the proposed modifications, should be regarded as the minimum upon which to build the enhanced framework that CESR is now suggesting. CESR considers that the updated Code satisfactorily addresses most of the concerns raised in the areas covered in the report except those regarding ancillary and advisory services where there is a need for more clarity. CESR has informed IOSCO about this concern.
9. Moreover, CESR does not consider the initiatives taken through the improvement of the IOSCO Code and the initiatives taken by the CRAs both as a group and individually, are sufficient given the influential role CRAs play in the structured finance sector. This leads CESR to believe there is a strong need to take a step forward in ensuring integrity and confidence in the rating industry and encouraging the effective use of ratings by investors.
10. **CESR therefore urges the Commission as an immediate step to form an international CRAs standard setting and monitoring body to develop and monitor compliance with international standards in line with the steps taken by IOSCO, using full public transparency and acting in a 'name and shame' capacity to enforce compliance with these standards via market discipline.**
11. **In order for this body to work, CESR believes it needs the full support of the market and considers that it should be formed of senior representatives of the investor, issuer and investment firms communities from across various geographic areas to ensure market buy-in and the international nature of the body. In addition, CRAs should also be part of the body when acting in its standard setting capacity but not when performing its monitoring activity. The members of the body would be appointed in the majority by the international regulatory community and would be accountable to those that appoint them.**
12. **CESR takes for granted that CRAs will provide sufficient information to this body in order for it to fulfil its monitoring objective.**
13. **If international regulatory involvement cannot be achieved in the short term, CESR recommends that this body is formed at an EU level.**
14. **In the absence of support from market participants or failure of the body to meet the objectives of ensuring the integrity and transparency of ratings, CESR considers that this initiative would not add value and that the supervisory authorities should step in to ensure, probably through regulation, the integrity and quality of the rating process.**



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I. INTRODUCTION

1. On 30 March 2005, at the request of the European Commission, CESR delivered its advice (CESR/05-139b) regarding the potential options to regulate Credit Rating Agencies (CRAs). In its advice, CESR proposed not to regulate the Credit Rating Agencies industry at an EU level for the time being, and instead proposed that a pragmatic approach should be adopted to keep under review how CRAs would implement the standards set out in the IOSCO Code of Conduct.
2. CESR therefore developed this strategy on the basis of voluntary participation from CRAs and in December 2005 published a press release outlining the process to review implementation of the IOSCO Code.
3. This framework, agreed with the main CRAs operating in the European Union, included three elements: (i) an annual letter from each CRA to be sent to CESR, and made public, outlining how it had complied with the IOSCO Code and indicating any deviations from the Code; (ii) an annual meeting between CESR and the CRAs to discuss any issues related to implementation of the IOSCO Code; and (iii) CRAs would provide an explanation to the national CESR member where any substantial incident occur with a particular issuer in its market.
4. DBRS, Fitch Ratings, Moody's, Standard and Poor's adhered to this voluntary arrangement.
5. In January 2006 the European Commission published a Communication setting out its approach to credit rating agencies. In line with the advice provided by CESR, the Commission concluded that at that moment no new legislative proposals were needed. The European Commission considered that the existing financial services directives, combined with self-regulation by the CRAs on the basis of the IOSCO Code, would provide an answer to all the major issues of concern in relation to CRAs. However, the communication concluded that there was a need for the Commission to monitor the global development of the rating business and for CESR to monitor compliance with the IOSCO Code and to report back to the Commission on an annual basis.
6. On 17 May 2006, CESR received a letter from the European Commission formally requesting CESR to report on credit rating agencies' compliance with the IOSCO Code by the end of 2006. In its formal letter the Commission requested CESR not only to carry out the theoretical work of comparing codes, but also to assess the level of day to day application of the IOSCO Code in practice.
7. In January 2007, CESR published the requested report (Ref. CESR/06-545), concluding that the CRAs did not fully comply with the IOSCO code when it came to unsolicited ratings and ancillary services. These areas, together with the structured finance area, were therefore decided to be further investigated in the next review.
8. In May 2007, CESR received a letter from the European Commission asking CESR to monitor the voluntary compliance with the IOSCO code and to prepare its second report.
9. In June 2007, CESR launched a questionnaire addressed to all interested parties regarding the rating of structured finance instruments. This call for evidence closed on 10 September 2007. A detailed analysis of the responses provided by the CRAs and by market participants to this questionnaire was included in section II of CESR's consultation paper and in Annex I. Furthermore, the responses are available on CESR's website under 'consultations'/ 'past consultations and responses'.
10. In September 2007, the Commission expanded its request to the CESR task force to include an investigation whether the recent developments within structured finance would cause CESR to change its view whether to regulate CRAs or not.
11. In particular, the Commission asked CESR to gather additional data in this year's report and provide its views about the following areas of the rating process regarding structure finance instruments:
 - Transparency of CRAs rating methodologies;



- Human resources allocated to rating and monitoring;
 - Periodic monitoring of the ratings and timeliness of rating actions;
 - Potential conflicts of interest (i.e. remuneration structures of CRAs).
12. As planned and envisaged in CESR's existing work plan, the CESR Task Force held separate hearings on the 4th and 5th of October with the 4 CRAs. During these sessions, the CRAs provided CESR with updated information on their codes of conduct, discussed the Commission's new request including their views on the sub-prime crisis and particularly on how they intended to address any possible shortcomings in this market.
 13. In November 2007, as a follow up to the meetings held with rating agencies at the beginning of October and in order to obtain the necessary data to fulfil the European Commission's new request, CESR sent a letter asking for additional information to the CRAs. CESR has published on its website the list of questions and the answers provided by the CRAs (except those expressly requested by the CRAs to be kept confidential).
 14. In February 2008 CESR published a consultation paper on the role of CRAs in structured finance (CESR/08-36) to seek market participants' views before the end of March 2008 on the main issues arising from the activity of the CRAs in the structured finance market and, in particular, on their views on possible policy options. CESR received 26 responses to its consultation before the closing date. Those that are public can be viewed at CESR's website. Besides, CESR organised an open hearing for interested market participants (rating agencies excluded) on the 26th March at CESR premises in Paris.
 15. CESR set up a task force responsible for following the steps outlined in CESR's voluntary framework and for developing the reports to the Commission discussed in the previous paragraphs. The task force, which is comprised of the same members as the one that prepared the March 2005 advice to the Commission, consists of representatives of CESR members from Belgium, France, Germany, Italy, The Netherlands, Portugal, Spain, Sweden and United Kingdom. The task force is chaired by Ms Ingrid Bonde, Director General of the Swedish Finansinspektionen and supported by Raquel García Alcubilla and Javier Ruiz from the CESR secretariat. In addition, representatives from the European Commission and from the Committee of European Banking Supervisors (CEBS) take part in the task force as observers.
 16. In this report CESR is not addressing the competitive dimension of the CRAs' market. CESR already addressed the competitive dimension of this market in its Advice (par. 246 to 252 CESR/05-139b) and concluded that the impact of regulatory requirements on competition is not clear and therefore it could not conclude that any regulatory requirements would either increase or decrease the entry barriers to the rating industry. Thus CESR did not recommend the use of regulatory requirements as a measure to reduce or remove entry barriers to the market for credit ratings.
 17. The source of information that CESR has used for the preparation of this report is the input received from the CRAs and market participants in the manner described above. As mentioned before, some of the information obtained from the CRAs has not been published as the agencies expressly requested that information to be kept confidential. The confidentiality refers mainly to human resources or revenue related data.
 18. Apart from the above, CESR has taken into account the main initiatives that are being undertaken by securities regulators and other governmental bodies to assess how markets have reacted to the structured finance market turmoil and how regulators and market participants are reacting. The main initiatives are described in section II of this report. As some of these initiatives are now underway but have not been finalised yet, CESR has not been able to factor into this report any conclusions made in these fora.
 19. CESR acknowledges that any initiative on rating agencies must follow this global perspective and, to this effect, the task force has worked in close co-operation with the following bodies:



- CEBS has participated as an observer to the task force meetings and its contributions have been very helpful for the task force.
- The SEC has showed its willingness to collaborate with CESR and has regularly updated the task force of the developments in the US. CESR secretariat has been invited to the SEC to get first hand information on the application of the new US legislation and representatives from the SEC have attended some of the task force meetings as observers.
- IOSCO's work has been closely followed by CESR, some of the members of IOSCO's CRAs task force are also members of the CESR CRAs task force. In addition to this, contact has been maintained between the Secretariat.



II. UPDATE ON THE INITIATIVES IN RELATION TO CRAS SINCE LAST CESR'S REPORT

A) EU COUNTRIES

Germany

20. A national meeting among market participants and German rating agencies held by BaFin in April 2007 highlighted concerns about some provisions of the IOSCO Code. These concerns were forwarded to the IOSCO to be considered as possible changes in IOSCO's Code of Conduct review exercise. Nevertheless, acceptance of the Code is high and since the last CESR report was published in 2007 some more German rating agencies adopted and published their own codes of conduct based on the IOSCO Code of Conduct with some others currently working on an own code of conduct.
21. In April 2008 a second national meeting with rating agencies operating in Germany and market participants took place in order to listen to the market's perception of the latest IOSCO Code of Conduct consultation paper. By and large changes in the Code of Conduct were welcome, but participants raised doubts about the practicability of a small number of the new provisions. These concerns together with a strong request for a section containing a number of clear definitions in the IOSCO Code of Conduct were forwarded to the IOSCO.

France

22. As described in CESR's first report published in December 2006, the AMF is required to publish an annual report on the role of credit rating agencies, their ethical rules, the transparency of their methods and the impact of their activity on issuers and on the financial markets. The AMF began publishing these reports in January 2005.
23. For its third report, published in January 2007, after an overview of the presence of these agencies in France and their activities, the AMF indicated that it continued to monitor developments in the French and international context in which rating agencies operate, as well as the efforts made by the rating agencies to comply with the provisions of the IOSCO Code. Of particular interest is the review made of the French market in long-term financial rating of companies and structured finance, updating the information presented in the studies conducted over the last two years.
24. The AMF's fourth report deals first with developments, including regulatory changes, in the international environment in which credit rating agencies (CRAs) operate. It also focuses on the new External Credit Assessment Institutions (ECAIs) and how the process for recognising them relates to implementation of the Basel II Accord on capital adequacy. The report then gives a detailed account of CRAs' role in corporate borrowing, their structure, their business model, their rating process and their relationships with different market participants. This analysis is backed up with a statistical description of the French credit rating market in 2006.
25. The AMF has also published two research papers on the subject of CRAs. The first entitled "Is Rating an Efficient Response to the Challenges of the Structured Finance Market?" was published in March 2007. This analysis focuses on the role of rating agencies in the structured finance market, and especially in the CDO market. The second one, "Analysis of Subprime RMBS Ratings in the USA" was published in January 2008 and looks at CRAs' behaviour towards subprime RMBS over the first ten months of 2007. It results in a number of factual observations regarding the frequency and type of rating actions during the period from January to October 2007.

Italy

26. Concerning regulatory issues, on May 2007, following the amendment introduced from Law 262 of 28 December 2005 to the article 114, par. 8 of the Consolidated Law on Financial Intermediation, Consob changed the article 69-decies of its Regulation no. 11971/99, concerning creditworthiness' evaluation.



27. In particular, the amendment to the article 114, par. 8 of the Consolidated Law on Financial Intermediation excluded the credit rating agencies from the application of the rules, concerning fair presentation of information and disclosure of conflicts of interest, previously introduced by the law which implemented the Market Abuse Directive.
28. Consequently, Consob decided to change its Regulation on this point, which before referred to the self-regulation of the subjects producing and disseminating the creditworthiness' evaluations; this previous regulation was largely due to the fact that at the European level an approach of self regulation had been adopted concerning CRAs.
29. The proposed change of the article 69-decies of Consob Regulation no. 11971/99, adopted after a public consultation, states that authorised persons and other persons who produce or disseminate credit ratings on a professional basis, excluding credit rating agencies, shall, when undertakings such activities, comply with the rules – concerning fair presentation and public disclosure of conflicts of interest – established for recommendations.

B) CEBS' UPDATE ON ITS WORK TO PROMOTE CONVERGENCE ON THE RECOGNITION OF EXTERNAL CREDIT ASSESSMENT INSTITUTIONS (ECAIS)

30. The Capital Requirements Directive (CRD) provides for the use of external credit assessments in the determination of the risk weights (and the resulting capital requirements) attributed to firms' exposures. Only credit assessments provided by recognised ECAIs are eligible for regulatory capital purposes.
31. In January 2006 CEBS published its guidelines for a common approach to the recognition of ECAIs under the CRD, establishing procedures for recognising both local and cross-border ECAIs, a common understanding of the eligibility criteria laid down in the CRD and a common approach for the mapping of an ECAIs credit assessment categories to regulatory credit quality steps (i.e. to CRD risk weights)¹. These procedures include a 'joint assessment process' which allows for greater consistency and efficiency when an ECAI is seeking recognition in more than one Member State.
32. In August 2006 CEBS published a press release announcing that the competent supervisory authorities across Europe, following the guidelines published by CEBS, had reached a shared view on the eligibility of Fitch Ratings, Standard & Poor's Ratings Services, and Moody's Investors Service for regulatory capital purposes and on the 'mapping' of their credit assessments.
33. In April 2007 CEBS published a similar press release announcing that the 11 competent supervisory authorities to whom DBRS had applied reached a shared view on the eligibility of DBRS for regulatory capital purposes and on the 'mapping' of its credit assessments.
34. The shared view is non-binding but forms a strong basis upon which, coherently with their national legal framework, competent authorities will take their final decision on formal recognition in each jurisdiction. In this context, most of the competent authorities involved in the joint assessment processes mentioned above have already formally recognised those ECAIs as eligible in their respective jurisdictions.²
35. A number of further applications were received from other ECAI applicants. The applications are currently being considered on their merits in line with the CRD and on the basis of the CEBS guidelines. In this context, joint assessment processes involving the competent supervisory authorities to whom the ECAIs applied are underway or already completed. The national competent authorities will take their final decision considering the outcome of the joint assessment process.

¹ Published on CEBS' website under: <http://www.c-eps.org/pdfs/GL07.pdf>

² For more information on the decision of the competent supervisory authorities on the recognition of ECAIs please consult the supervisory disclosure framework at CEBS' website: http://www.c-eps.org/sd/Rules_ECAI.htm



36. Against the terms of the CRD and CEBS' guidelines, CEBS' members are currently jointly reviewing if the 4 pan-European ECAIs for which a joint assessment process was already concluded (i.e. Fitch Ratings, Standard & Poor's Ratings Services, Moody's Investors Service and DBRS) continue to meet the eligibility criteria laid out in the CRD on an ongoing basis, and the mapping of their credit assessment categories to regulatory credit quality steps still adequately reflects the credit risk associated with them.
37. The focus of the ongoing review is mainly on two aspects: material or anticipated changes to the methodologies and the "mapping" of ECAIs' credit assessment categories of securitisation positions to the CRD risk weights. Moreover, the information policy and overall transparency will be taken into account.
38. For the review of the mapping a quantitative study is being carried out on the basis of the year-end 2007 default rates and transition data for the securitisation issues; this data is being provided by the ECAIs as soon as it becomes available. In the quantitative study, default rates associated with credit assessment categories and transitions data are being studied and compared; the data is also been seen in their context and compared with historical data from previous years. In particular the following issues are being analysed: 1) whether the credit assessments continue to demonstrate discriminatory power, and are stable and consistent; 2) Are historical default rates and transitions during 2007 in line with expected default rates at the start of 2007?; 3) ECAIs' timely review of their credit assessments; and 4) potential changes in market acceptance (up or downgrade followed by a price-adjustment?).
39. Preliminary results on the ongoing review are expected by the end of the first half of 2008.

C) UNITED STATES: ANALYSIS OF THE NEW US LEGISLATIVE FRAMEWORK

US legislation

40. Since 1975, the US have had a system where on request the SEC would identify, through the issuance of a "No Action Letter," a CRA as a Nationally Recognized Statistical Rating Organization ("NRSRO"). The NRSRO status confirmed that the CRA was nationally recognised by the predominant users of credit ratings as issuing credible and reliable ratings. Yet, the SEC did not have a mandate to organise oversight of the credit rating agencies. There was also a lack of transparency of the process and criteria to qualify as NRSRO.
41. Following various financial scandals in the beginning of the century, it was agreed in the US that CRAs were important enough to the stability and confidence in the financial markets that the introduction of explicit regulatory oversight and formal registration was deemed necessary.
42. In September 2006, the US Congress adopted the Credit Rating Agencies Reform Act of 2006 ("CRA Reform Act") which was enacted to *'improve the ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the CRA industry.'*³ The CRA Reform Act and the implementing rules of the SEC⁴ are largely consistent with the IOSCO Code principles but differ significantly in the level of detail. The US legislative framework renews the status of NRSRO with the introduction of a comprehensive voluntary registration system for CRAs with explicit regulatory oversight by the SEC. Registered NRSROs must also comply with record-keeping and disclosure requirements, provisions on management of conflicts of interest and procedures which a NRSRO needs to have in place to prevent misuse of non-public information and engagement in abusive practices. Further, NRSROs

³ S. 3850 [109th]: Credit Rating Agency Reform Act of 2006.

⁴ The CRA Reform Act provides the SEC with rulemaking authority to prescribe i) the form of the application (including requiring the furnishing of additional information); ii) the records the NRSRO must make and retain; iii) the financial reports a NRSRO must provide to the SEC on a periodic basis; iv) the specific procedures the NRSRO must implement to manage the handling of material non-public information; v) the conflicts of interest an NRSRO must manage or avoid altogether, and vi) the practices that an NRSRO must not engage in if the SEC determines they are unfair, coercive or abusive.



are subject to examination by the SEC. Since the CRA Reform Act became effective in June 2007, nine CRAs have registered as NRSROs under the new legislative framework⁵.

43. Under the registration requirements, certain information submitted in the application must be made publicly available on the website of the NRSRO to allow users of credit ratings to understand the methodologies, procedures and business models of the NRSRO⁶. Generally, the Form NRSRO must be promptly amended if the information on the Form becomes materially inaccurate. The implementing rules of the SEC require that only the operating division of a larger entity needs to register as the NRSRO provided the records of the operating division's credit rating activities are separately created or maintained. In addition, the registration should include the requisite number of institutional investors' certifications (two for each class of credit rating for which registration is sought and at least 10 with an initial application). Moreover, aggregate information about credit analysts (total number, minimum required qualifications and compensation) must be submitted for registration as an NRSRO. On a confidential basis, a list of the twenty largest issuers and subscribers that use the credit rating services concerned must be provided to identify persons that could potentially exert undue influence on an NRSRO. The CRA must also provide, on a confidential basis, audited financial statements, certain information regarding revenues for the firm's most recent fiscal or calendar year, and the total and median annual compensation of credit analysts.
44. The new legislative framework includes many record-keeping requirements which are regarded as the primary means of monitoring CRAs' compliance. In addition, several types of conflicts of interest which may adversely impact the ability of an NRSRO to operate as a rating agency and which are not a necessary consequence of how CRAs operate (e.g. conflicts relating to person being source of 10% or more of total net revenue of NRSRO or where NRSRO is associated with person that is subject to the credit rating) are now prohibited. Other types of conflicts must be disclosed and managed so that users of credit ratings can assess whether the conflicts impact the NRSRO's judgment.
45. With regard to the public disclosure of rating procedures and methodologies, NRSROs are required to publish a description of the rating procedures and methodologies they use for credit ratings which should be detailed enough for users to understand the processes that are employed to determine the credit rating. In addition, NRSROs have to internally document their rating procedures and methodologies and make them available for oversight purposes by the SEC.
46. Finally, the designation of a compliance officer is explicitly required and unfair, coercive or abusive activities of NRSROs are prohibited. Contrary to the 'comply or explain' approach under the IOSCO Code, the SEC can undertake enforcement actions including censure, denial, suspension or revocation of the registration in case it deems it necessary for the protection of investors and in the public interest.

President's Working Group

47. Following the global market turmoil, the President's Working Group on Financial Markets ("President's Working Group") has published on 13 March 2008 its recommendations to help avoid a repeat of recent events⁷. The President's Working Group paper includes recommendations for the reform of rating processes and practices regarding structured finance products. Among others, the President's Working Group encourages CRAs to improve their rating and disclosure processes and indicates that the US regulators concerned will reinforce the steps taken by CRAs through revision of the supervisory policies and regulation. If the reforms adopted by CRAs are not sufficient to ensure the integrity and transparency of ratings, the President's Working Group will revisit the need for changes to CRA oversight.

⁵ These 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., Standard & Poor's Ratings Services, LACE Financial Corp. and Egan-Jones Rating Company.

⁶ Information on users of credit ratings, revenues and financial statements of the CRA and compensation of credit analysts is filed with the SEC on a confidential basis and is not required to be disclosed by the NRSRO.

⁷ See http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf



D) FINANCIAL STABILITY FORUM (FSF)

48. In October 2007, the G7 Ministers and Central Bank Governors asked the FSF to analyse the causes and weaknesses underlying the market turmoil and to make recommendations to increase market and institutional resilience for the future. The FSF was asked to report to the G7 Ministers and Governors at their April 2008 meeting.
49. The FSF's members⁸ spent the following weeks and months in intensive collaboration resulting in the publication on April 11, 2008 of their "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience". In the foreword to the report, the FSF points out that national authorities took a number of measures to re-establish confidence in the soundness of markets and financial institutions and that although they may continue to consider short-term policy responses, they also considered it important to propose concrete actions designed to enhance the resilience of the global system. These steps are concentrated in the following five areas:
- Strengthened prudential oversight of capital, liquidity and risk management
 - Enhancing transparency and valuation
 - Changes in the role and uses of credit ratings
 - Strengthening the authorities' responsiveness to risks
 - Robust arrangements for dealing with stress in the financial system.
50. The report highlights the important role played by credit rating agencies in evaluating information on structured financial products and the reliance placed on their ratings by investors. It also recognises that the agencies themselves have begun to take steps to draw lessons from recent events for their internal governance and practices but believes that more is needed.
51. The recommendations of the FSF report that relate to the credit rating agencies cover the following 4 areas:
- Quality of the rating process
52. The FSF report notes that one of the triggers of the turmoil in the markets was the plunge in confidence in ratings of structured credit products caused, at least in part, by the rapid and sometimes severe downgrades in the originally highly rated RMBS and CDOs, thus raising questions about the quality of the ratings and rating process as related to these products.
53. In particular, the potential impact of conflicts of interest, more significant in the rating of structured finance products than that of other products, is raised. These conflicts of interest may relate to the "issuer-pays" model and/or to the interaction of the rating agency with the issuer/arranger during the structuring process and may be exacerbated when the agency also provides consulting services. The report goes on to indicate that the ratings performance may also have been damaged by flaws in the rating methodologies as well.
54. The flaws in methodology that the report refers to 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 points out that, in particular, the agencies underestimated the correlations in the defaults that could occur in the event of a wide market downturn.
55. The report notes that the rating agencies are taking measures to address the conflicts of interest concerns and improve the rating process, but stresses that more must be done in terms of internal governance and transparency of the rating process, as well as compliance with the IOSCO Code

⁸ Members include IOSCO, BCBS, IAIS, IASB, CGFS, CPSS, BIS, IMF and national authorities in key financial centres.



of Conduct. In addition, the rating agencies are encouraged to improve their disclosure of ratings performance in a systematic and easily comparable manner.

56. The specific recommendations made by the FSF in this domain are the following:

IV.1 IOSCO will revise its Code of Conduct Fundamentals for Credit Rating Agencies by mid-2008 to:

- *improve the quality of the rating process including the models, methodologies and information used for ratings (e.g., by CRAs creating an independent function to conduct periodic reviews);*
- *address conflicts of interest, including concerns about analyst remuneration and about the separation of consulting and rating activities; and*
- *provide investors with additional information on the methodologies and criteria used for ratings, how CRAs address data limitations, and data on the historical performance of ratings.*

IV.2 CRAs should quickly revise their codes of conduct to implement the revised IOSCO CRA Code of Conduct Fundamentals. Authorities will monitor, individually or collectively, the implementation of the revised IOSCO Code of Conduct by CRAs, in order to ensure that CRAs quickly translate it into action.

In terms of resources the FSF states:

IV.3 CRAs should demonstrate that they have the ability to maintain the quality of their service in the face of rapid expansion of their activities, and allocate adequate resources to both the initial rating and to the rating's regular review.

2. Differentiated ratings and expanded information on structured products

57. The FSF highlights the inherent differences in the ratings of structured products from those of traditional debt issues:

- they are based on models and more largely driven by underlying assumptions;
- the rating process is driven by the desire to achieve a certain rating, the structure of the product will therefore be adapted accordingly;
- the ratings may rely on non-public information about some of the assets; and
- they are potentially more volatile.

58. The technique of pooling of the assets flattens the risk of each individual asset and thus the average credit performance of the pools tends to be less volatile and more predictable, under normal circumstances, than the individual assets. However, any economic event that impacts the creditworthiness of several of those assets at one time will have a much greater impact on the asset pool due to the correlations of their defaults thereby increasing the risk of significant downgrades of the ratings. Notwithstanding these differences, the FSF notes that the rating agencies apply the same rating categories to both corporate bond and structured finance products. It stresses that many investors did not understand fully these differences and that additional information should therefore be provided on the risk characteristics of structured products. The report finds that rating agencies should, therefore, differentiate ratings on these products from those of corporate and sovereign bonds. The FSF also stresses that the rating agencies should document the sensitivity of structured finance ratings to changes made to the central assumptions.

59. As mentioned above, the pooling of assets reduces the risk of individual assets but could increase the exposure of the pool to systemic or economic risk factors. It is for this reason that the assumptions and analyses made by the rating agencies regarding economic and other systemic factors are an essential element in understanding and using ratings correctly. The FSF therefore recommends that the agencies give investors access to the assumptions and underlying scenarios used in the rating process.

60. The FSF's findings in this domain are provided below:

IV.4 CRAs should clearly differentiate, either with a different rating scale or with additional symbols, the ratings used for structured products from those for corporate bonds, subject to appropriate notification and comment.

IV.5 CRAs should expand the initial and ongoing information that they provide on the risk characteristics of structured products, including:

- *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;*
- *information about their loss and cash-flow analysis of structured products;*
- *information on limitations of rating analysis due to insufficient data or untested models, including rating uncertainty; and*
- *standardised initial and ongoing performance reports, especially for re-securitised products.*

3. CRA assessment of underlying data quality

61. The FSF notes that, as shown by the subprime crisis, the quality of the data used by the rating agencies in the rating process has a significant impact on the accuracy of those same ratings. It acknowledges that the responsibility for providing adequate and timely information on the underlying assets lies with the issuers, originators and arrangers of the structures, but stresses nonetheless that the rating agencies should review the quality of the data and evaluate and disclose the level of due diligence performed by originators, arrangers and issuers. The report's conclusion on this topic is as follows:

IV.6 CRAs should review the quality of the data input and the due diligence performed by originators, arrangers and issuers. To this end, CRAs should:

- *require underwriters to provide representations about the level and scope of due diligence that they have performed on the underlying assets;*
- *adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating;*
- *establish an independent function to review the feasibility of providing a credit rating for new products materially different from those currently rated;*
- *refrain from rating a security in cases where the complexity or structure of a new type of structured product, or the lack of robust data about underlying assets, raises serious questions as to whether CRAs can determine a credit rating;*
- *disclose what qualitative reviews they perform on originators' underwriting standards; and*
- *take into account the information on the portion of underlying assets held by originators when rating securitised products.*

4. Uses of ratings by investors and regulators

62. The FSF highlights their findings regarding the over-reliance on ratings by investors and stresses the fact that the ratings should not replace the need for risk analysis and management by investors. The improvements in the quality of the rating process and in the information provided by the rating agencies will be of limited benefit, if they are not used by investors. The FSF states this in the following manner:

IV.7 Investors should reconsider how they use credit ratings in their investment guidelines and mandates and for risk management and valuation. Ratings should not replace appropriate risk analysis and management on the part of investors. Investors should conduct risk analysis commensurate with the complexity of the structured product and the materiality of their holding, or refrain from such investments.

63. The report also indicates that the reference to ratings in a variety of regulatory and supervisory frameworks may have contributed to the tendency of investors to over-rely on the ratings.



Furthermore it points out that the potential impacts of regulatory recognition should be monitored by authorities.

IV.8 Authorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.

E) IOSCO

Background

64. In late 2004, IOSCO released the CRA Code of Conduct Fundamentals as a result of a Task Force project that involved securities regulators, Basel Committee members and the CRA industry. The purpose of the Code was to strengthen transparency and address potential conflict of interests essentially through a “comply or explain” approach.
65. In February 2007, IOSCO released a report for consultation on the level of implementation of the IOSCO Code by the CRAs. This report was publicly released for comments. Comments received from CRAs, issuers, investor groups and other market participants, generally supported the Technical Committee’s conclusions.
66. In March 2007, the Financial Stability Forum (FSF) requested that IOSCO, the Committee on Global Financial Systems (CGFS) and other interested member bodies would explore whether there were any outstanding issues related to the role of CRAs in structured finance. IOSCO’s Technical Committee, at its meeting in April 2007, agreed that its Credit Rating Agencies Task Force would undertake a study of how CRAs go about rating structured finance products and whether any amendments should be made to the IOSCO CRA Code of Conduct to reflect conflicts of interest or other problems that may arise in rating structured finance products.

Recent Developments

67. On 26 March 2008, the IOSCO Technical Committee published a Consultation Paper on the Role of Credit Rating Agencies in Structured Finance Markets⁹. The objectives were to consult market participants on the adequacy of IOSCO analysis of the role of credit rating agencies in structured finance markets and on proposed recommendations for amendments to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. Recommendations for modifying the IOSCO Code refer to the reinforcement of provisions concerning to the quality and integrity of the rating process, independence and prevention of conflicts of interests, to the CRAs responsibilities to the investing public and issuers and to the disclosure of CRAs Codes of Conduct and communication with market participants.
68. The consultation paper proposes making the following revisions under three main areas of the Code of Conduct:

Section 1 - Quality and Integrity of the Rating Process

Key proposed changes in this area require that CRAs should:

- ensure that the decision-making process for reviewing and potentially
- conduct the downgrading of a rating of a structured finance product in an objective manner;
- establish an independent function responsible for periodic reviews of the firm’s rating methodologies and models;

⁹ <http://www.iosco.org/news/pdf/IOSCONEW14.pdf>



- take reasonable steps to ensure that the information they use is of sufficient quality to support a credible rating. Ratings involving products with limited historical data should have these limitations made clear;
- refrain from rating a product if the complexity or structure of a new type of rating creates doubts about the feasibility of a rating action; and
- prohibit analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.

Section 2 - CRA Independence and Avoidance of Conflicts of Interest

Key proposed changes in this area require that CRAs should:

- establish policies and procedures for reviewing the work of analysts who leave to join an issuer the CRA rates, or a financial firm with which the CRA has significant dealings;
- conduct formal and periodic reviews of remuneration policies and practices for its employees to ensure that these policies do not compromise the CRA's rating process;
- disclose whether any one client and its affiliates make up more than 10 percent of the CRA's annual revenue; and
- define what it considers and does not consider to be an ancillary business and why.

Section 3 - CRA Responsibilities to the Investing Public and Issuers

Key proposed changes in this area require that CRAs should:

- assist investors in understanding what a credit rating is, the attributes and limitations of each credit opinion, and the limits to which it verifies information provided to it by the issuer of a rated security;
- disclose on a periodic basis all cases where an issuer of a structured finance product has asked the CRA for a preliminary rating of the proposed structure, but does not subsequently contract that CRA for a final rating, or contracts for a final rating and does not publish it but does publish the ratings of another CRA for that same product;
- when rating a structured finance product, provide investors/subscribers with the information to understand the basis for the CRA's rating;
- disclose whether it uses a separate set of rating symbols for rating structured finance products, and why; and
- disclose the methodology or methodology version in use in determining a rating.

69. IOSCO has required comments are submitted to them by 25 April 2008.

F) CRAS INITIATIVES

70. A number of CRAs have been begun both individual and concerted initiatives to address concerns posed by regulators and market participants, in relation to credit ratings.

CRAs joint initiative

71. In October 2007, a group of credit rating agencies, including A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc.; Moody's Investors Service, Inc.; and Standard & Poor's Ratings Services (the "Participating CRAs") began working together in response to calls by government authorities and market participants for important players in the credit markets, including credit rating agencies, to suggest measures to enhance confidence in the credit rating process, particularly with respect to structured finance securities. Since then, the Participating CRAs have collectively considered means by which the independence, quality and transparency of credit ratings could be enhanced. They have communicated their views on those subjects to regulators and legislators, by circulating a discussion paper in December 2007¹⁰ in which the Participating CRAs made certain proposals regarding enhancing the independence, quality and transparency of credit ratings, engaging in dialogue with regulators and market participants, and submitting a collective response to CESR's Consultation Paper on the Role of Credit Rating Agencies in Structured Finance.

¹⁰ Discussion Paper about Measures to Enhance the Independence, Quality and Transparency of Credit Ratings



72. The Participating CRAs continue to meet to discuss and develop potential initiatives and measures aimed at promoting confidence in the credit rating process and structured finance market. In their latest update¹¹ the group is presenting a number of recommendations that the members are committed:

- Plainly stating that the Participating CRAs do not and will not provide consulting or advisory services to the issuers they rate, nor do their analysts make proposals or recommendations regarding the structure or design of structured finance products.
- Conducting regular, periodic reviews of staffing needs, training and competencies, as well as formal, internal reviews of remuneration policies and practices to ensure that they do not compromise analyst objectivity.
- Working with market participants on measures that could enhance the quality and transparency of information regarding assets underlying structured finance securities available to the investing public.
- Creating an industry portal to house the Participating CRAs' performance studies and other relevant data.
- Providing more disclosure about key model and methodology assumptions and stress-testing of assumptions.

73. As soon as the recommendations from the regulatory community, such as IOSCO, FSF and CESR, are finalized, the participating CRAs have stated that they intend to move swiftly to amend their respective codes of conduct, as appropriate, and adopt any other needed changes whose implementation necessarily depends upon the final recommendations of the policy-making bodies. While each Participating CRA is likely to have a different implementation schedule, they expect that a number of changes will occur in 2008. In the meantime, they have individually started to implement changes and each Participating CRA has been working to enhance its own policies, processes, methodologies and reports, as appropriate.

74. CESR encourages these initiatives, however CESR considers it is too early to judge their actual impact.

Individual initiatives

75. In addition to the joint initiative CRAs are individually taking different steps to enhance the quality of their ratings, the independence of their process and the transparency of their performance

76. The measures which have been adopted by **DBRS** include:

- Strengthening and clarification of policies and procedures dealing with impact assessments, unsolicited ratings, analyst restrictions in fee discussions and conflicts of interest in respect of securities ownership.
- Quality reviews of key rating processes, policies and procedures to determine additional improvements including appropriate disclosure of Structured Finance transaction risks and the governance of methodologies and quantitative rating models.
- Publish more policies and processes publicly on their website, dbrs.com.
- Mechanisms to improve the transparency and link between methodologies, Rating Committee and published rating reports for Corporate Finance and Structured Finance.
- Internal and external education regarding the financial crisis, ABCP and other Structured Finance products.
- Comprehensive review of all ABCP products and enhanced rating procedures and standards.
- Methodology and criteria committee to review, update and monitor Structured Finance methodologies and models.

¹¹ Credit Rating Agencies' Statement and Progress on Initiatives to Strengthen CRA Performance and Enhance Confidence in the Credit Rating Process, April 2008.



- Ongoing separation of new ratings and rating surveillance functions in Structured Finance.

77. **Fitch** has adopted the following measures:

- separated its non-rating businesses into a separate division, Fitch Solutions.
- 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.
- an operational review of major asset class criteria has led to the revision of their approach to residential mortgage ratings in the US and to the ratings of collateralised debt obligations and market value products globally.

Fitch is working on further initiatives including:

- enhancements to the formal internal training programs for analysts and greater external investor education efforts
- improvement of 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.

78. **Moody’s** has begun a number of initiatives including:

- measures to enhance analytical methodologies by various analytical modifications summarized in a recently published report.¹²
- a series of proposals, on which it is seeking comment, on ways to improve the quality of the underlying data provided by originators and underwriters¹³.
- measures to provide more clarity about the credit characteristics of Structured Finance Ratings. Moody’s is discussing possible alternatives for differentiating structured finance ratings from non-structured finance ratings, including the provision of more information about the credit characteristics and performance of structured finance ratings. They have recently completed a consultation survey on this issue and have indicated that they plan to publish the results in May.
- measures to further enhance the independence of its rating process by:
 - reorganizing its operating businesses to formalize the separation of its ratings-related and non-rating activities into two different business units.
 - taking further steps to separate the Credit Policy function from parts of the rating agency with revenue-generating responsibility.
 - establishing a Global Structured Finance Surveillance Coordination Function.

79. **Standard & Poors** has announced that it intends to take a number of steps to enhance the integrity of their ratings process, including:

- complement traditional credit ratings analysis by highlighting non-default risk factors that can influence the performance of rated securities. S&P will also provide greater transparency and insight to market participants by a number of measures including more market education.
- improve surveillance process through additional resources and ongoing separation of new ratings and rating surveillance functions in structured finance.
- establish an independent Model Oversight Committee to assess and validate the quality of data and models used.
- establish an Office of the Ombudsman that will address concerns related to potential conflicts of interest that may be raised by issuers and investors among others.

¹² Updates to Moody’s U.S. Structured Finance Ratings

¹³ Request for Comment: Moody’s Proposed Enhancements to U.S. Residential Mortgage Securities: Call for Comments

http://www.moodys.com/moodys/cust/research/MDCdocs/26/2007100000485953.pdf?doc_id=2007100000485953&frameOfRef=structured



S&P will provide updates of progress on an ongoing basis¹⁴. The latest update was issued on 10 April and highlights the following progress by announcing that S&P:

- will engage an external firm to review their compliance and governance processes by year end. They will also hold periodic Audit Committee reviews of these processes.
- have established a risk assessment oversight committee which will assess risks to the rating process and feasibility of rating new types of securities.
- have identified a list of non-default risk factors and requested feedback from market participants by mid-year. They will commence research coverage by year end 2008.
- are developing a framework for including “what if” scenario analysis to explain key rating assumptions and the potential impact of positive or negative events on the rating to be introduced by year end for certain securities.
- have increased RMBS surveillance staff to improve the surveillance process.
- are introducing a number of measures focusing on data integrity for structured security ratings.

G) OTHERS

i) ISO Standards: Background information on the standards project ISO/PC235 of the International Organization for Standardization (ISO).

80. The ISO standards project "credit assessment" was launched via the German Institute for Standardisation (Deutsches Institut für Normung - DIN), and aims at developing an international standard with basic requirements for rating processes.

81. In Germany, the issue was raised by the Federal Association of Rating Analysts and Rating Advisors (Bundesverband der Ratinganalysten und Ratingadvisor - BdRA), which is also DIN's main cooperation partner. The German working committee, which has been established under the umbrella of DIN, is made up of rating analysts as well as staff and owners of rating agencies. The experts from other countries have similar professional backgrounds.

82. DIN submitted the project proposal to ISO in 2006. Following the acceptance and confirmation of a chairman, the first meeting took place in March 2007. The next round of negotiations is planned to take place in Vienna at the beginning of October 2008.

83. The project process is managed by DIN, which expects the project duration to be approximately 3 years and contains the following steps:

Draft International Standard End of 2008

Final Draft International Standard End of 2009

International Standard Summer 2010

84. This standard will specify terms, definitions and basic requirements on processes for credit assessment of companies and other legal entities. Consumer scoring and securities assessment will not be within the scope of a potential new standard.

ii) European Securities Markets Expert Group work on CRAs

85. In parallel to the request for comprehensive review made to CESR, the European Commission has also sought advice from European Securities Markets Expert Group (ESME).

86. The report produced by ESME is expected by end of May 2008 and will serve, in addition to the CESR's review, as technical background, which the European Commission will use to complete its

¹⁴ <http://www.spnewactions.com/>



assessment of the rating agencies' activities and in particular the rating process following the recent developments in the financial markets.

87. In broad terms ESME has been asked to:

- provide its views on the role of CRAs and the importance and meaning of ratings in the financial markets, and in particular in the field of structured finance;
- to look into the functioning of the (self) regulatory framework in the EU for CRAs, taking into account the new US Act Credit Rating Agency Reform Act of 2006 which entered into force in June 2007.
- The focus of ESME analysis is on the financial industry experiences with the existing patterns of CRAs activity as well as their implications on the efficiency and integrity of the financial markets.

iii) Committee on the Global Financial System (CGFS) Report

88. The Committee on the Global Financial System (CGFS) is a central bank forum for the monitoring and examination of broad issues relating to financial markets and systems with a view to elaborating appropriate policy recommendations to support the central banks in the fulfilment of their responsibilities for monetary and financial stability.

89. The CGFS formed a working group, against the backdrop of credit market turmoil and a request by the Financial Stability Forum, to update its January 2005 report on 'The role of ratings in structured finance: issues and implications.' Alongside an analysis of particular issues identified with the rating of US sub-prime backed securities the final report is expected to cover the role ratings play in investor risk assessment and portfolio allocations; the difficulties and unique risks presented by structured finance products; and present recommendations for improving the transparency and robustness of credit ratings.



III. THE RATING PROCESS AS REGARDS STRUCTURED FINANCE INSTRUMENTS

A. BACKGROUND

The role of CRAs in structured finance

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 pools¹⁵, 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% yoy¹⁶ 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 (heterogenous) collateral assets but also to have sufficient insight into the legal structure and the specific provisions of the transaction (eg, 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

¹⁵ As defined in the BIS report, “The role of ratings in structured finance: issues and implications”, January 2005.

¹⁶ Year on year: comparing the first half of 2007 with the first half of 2006.



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.

Why is this an issue for review?

97. The role of CRAs in structured finance issuance has been a source of debate for some time. In previous reports, CESR had already questioned the implications of this role on CRAs' independence and the possibility of increased risk of conflicts of interest.
98. However, the recent US subprime mortgage driven crisis has brought the concerns regarding the role of CRAs in structured finance ratings and the need for a thorough analysis of their involvement in the current turmoil to the forefront of the international regulatory agenda.
99. An aspect that has been highlighted regarding the rating of structured finance instruments is the fact that CRAs are paid fees by issuers and not by investors. Although this is also the case with corporate ratings, the nature of structure finance means that issuers and arrangers can bring repeat business to the CRAs. This might drive them to favour business volume instead of rigorousness and independence and hence to 'overrate' transactions in order to maintain a profitable flow of business from arrangers. This issue has already been largely debated before, CRAs explaining that their reputation risk was an effective counterbalance. However, the surge in structured finance fees which are based on an initial transaction fee plus a fixed fee for monitoring (and potential consequent rise in directors/analysts remuneration), combined with the iterative approach to these ratings in comparison to corporate ratings necessitates a review of this issue.
100. A related issue is that of CRAs' analysts taking part in fees negotiation. Although this practice is in opposition with principle 2.12 of the IOSCO Code of Conduct and CRAs adhere to the general rule, some CRAs have admitted there are exceptions. 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 fees¹⁷. However, as summarized in the last section of the consultation paper the CRAs have made improvements in this respect.
101. Some observers have also raised concerns about the limited number of investment banks bringing structured finance business to CRAs, increasing the risk of client dependency and hence of conflict of interest.
102. Another area of potential conflicts of interest that has already been identified and focused on by the IOSCO Code of Conduct is the issue of "ancillary services". Although the scope of these services is sometimes difficult to define (eg. is a rating assessment service part of the rating services or is it an ancillary service?), the IOSCO Code requires operational and legal separation of the credit rating business from any other business undertaken by CRAs that may present a conflict of interest. CESR's 2006 report¹⁸ to the EC on the compliance of CRAs with the IOSCO Code pointed to the deviation of some CRAs from this principle.
103. With regard to structured finance, the continuous innovation seen in the market has resulted in the creation of more and more complex instruments, increasing the opacity for investors. As a result, investors have come to heavily rely on ratings and CRAs' rating reports as a source of

¹⁷ See CESR's 2006 report (CESR/06-545), §51.

¹⁸ Ibidem.

information, including for purposes for which ratings were not designed (ratings being indicators of default risk only). This trend has been exacerbated by the lack of a liquid market for these securities leading to problems in pricing them efficiently. As a result of the demand from investors lacking sufficient information to be able to mark-to-market these securities, some CRAs have developed pricing services for structured finance securities. Although CRAs claim that the pricing services they offer are independent from the rating services, market participants have pointed out that there is a need to clarify the level of interaction between those two businesses and the controls in place to prevent conflicts of interest affecting ratings. Examples of possible conflicts are the potential use of information gathered for the rating process to later price the security or the potential reluctance of the CRA to unfavorably price a security to which it has itself attributed a superior rating. The questions posed by the offering of these services have become all the more acute in the context of the recent turbulence in the markets that has highlighted the importance of the valuation of assets.

104. A key issue with regard to pricing and lack of transparency is the fact that, as ratings have become a significant, if not the most significant, factor in the marketing of structured finance securities and also become a prime source of information for investors, the market seems to have disregarded the limitations of ratings in gauging the risk of structured finance products and to have lost sight of core risk management principles. This trend may be summed up in the following: “it’s AAA rated so it’s safe, valuable and liquid”. While the subprime mortgage crisis had already been evident for some months, a lot of investors seem to have discovered only late in the day that some of the investment grade rated products they had bought were in fact heavily exposed to subprime mortgage bonds. They also appear not to have been aware that the liquidity characteristics of these products differed significantly from corporate bonds, particularly in an adverse market environment.
105. Although CRAs state that ratings are not designed to be, and cannot be, predictors of market prices or product liquidity, the question of the lack of investor’s comprehension of the role of credit ratings in structured finance needs to be raised for consideration by CRAs and regulators. It is linked to the issue of the availability of ratings reports and deal documentation but also to the intrinsic quality of the information made available by arrangers and the CRA. There clearly appears to be a widespread misunderstanding of CRAs do’s and don’ts about structured finance, of what information ratings provide or not, of their reliability and the extent of comparability between, for example, an AAA-rated corporate bond and an AAA-rated CDO tranche. As described in the BIS report¹⁹, “a number of investors... claim to rely almost exclusively on the rating agencies’ pre-sale reports and rating opinions for information on deal specifics and performance”. If this is the case, either the information provided was not sufficient to form an educated opinion and perform a risk assessment of deals, or investors did not do their homework correctly, or both.
106. Last but not least, 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. However, the CRAs point out that the very nature of structured finance leads to a delay in the response of ratings to the underlying asset pools – which becomes more pronounced the further the product is from the underlying – i.e. a CDO reacts after underlying RMBS due to trickle through effect. Respondents to the CESR survey raised questions about the ability of CRAs to keep up with the accelerated wave of financial innovation and the surge in issuing volume from a modelling and human resources point of view. Also practices such as notching, i.e. downgrading by one or more ‘notches’ the rating of an underlying asset attributed by a competitor have been questioned. Finally, in order to improve market understanding of structured finance ratings and rating changes, the transparency of these methodologies, of the way they are applied and of their implications is also under review.

¹⁹ “The role of ratings in structured finance: issues and implications”, January 2005.



B) DESCRIPTION OF THE LEGAL FRAMEWORK IN THE EU: LEGISLATIVE APPROACH TO STRUCTURED FINANCE RATING WITHIN THE EU

Summary

107. For the preparation of this report, CESR gathered some background information on the existing legislative approach to structured finance ratings within the EU. To this effect, in May 2007, CESR members were invited to provide information on whether they had in their country legislation, rules or competent authorities' guidelines regarding the rating of structured finance instruments and to explain briefly the main aspects of such legislation.
108. Of all the countries responding to CESR only Italy had any specific legislation, rules or guidelines for the rating of structured finance products. France and Spain do however have laws requiring ratings in the placement or listing of certain securities.
109. The list of all responding countries in which there is no specific legislation, rules or guidelines for the rating of structured finance products is as follows: Austria, Belgium, Cyprus, Finland, Germany, Latvia, Lithuania, The Netherlands, Norway, Portugal, Slovakia, Slovenia, Sweden and the UK.

France

110. Whilst France has no official regulation of the rating of structured finance, their response highlighted that several French laws create a requirement for ratings in the placement or listing of securities, thus assigning the agencies a role in the information and protection of investors in certain cases. Furthermore, the Financial Security Act of 1 August 2003 assigns the AMF the task of publishing an annual "report on the role of [credit] rating agencies, their ethical rules, the transparency of their methods and the impact of their activities on[...] issuers and [...] financial markets" (Article L. 544-4 of the Monetary and Financial Code, introduced by Article 122 of the Act).
111. In collective investment schemes, securitised debt funds (Fonds Communs de Créances – FCCs) may be required to obtain ratings. This requirement arises when the securitised debt fund is going to make a public offering of securities, in other words when it places its securities or when they are listed. A document containing an assessment of the characteristics of the fund units and, where applicable, the debt securities the fund intends to acquire and the financial futures contracts it intends to enter into, as well as an evaluation of the risks incurred, shall be drawn up by an organisation chosen from a list of CRAs²⁰ established by the Minister for the Economy after consulting the Financial Markets Authority (AMF). This document is appended to the prospectus and sent to investors subscribing to units in the fund and, where applicable, the fund's debt securities.

Spain

112. The rating of structured finance instruments is not regulated in Spain. However, the special purpose entities that offer the asset backed securities to the public and/or admit them to trading on a regulated market need approval by the Spanish securities supervisor (CNMV). Both the structure of the transaction and the public offer/admission prospectus require approval and are subject to the CNMV's oversight. The same regulations require that the abovementioned securitizations are rated by a credit rating agency that has been previously recognized by the CNMV for this purpose. Moreover, the CNMV has the power to require a minimum investment grade for the most senior tranche of a public offer of asset backed securities. Finally, the Spanish government has the power to partially guarantee securities backed by loans to small and medium sized companies meeting certain criteria, on condition that the securities have obtained a certain

²⁰ In a ministerial order dated 28 December 2006, the Minister established a list of four agencies: Dominion Bond Rating Services; Fitch Ratings; Moody's Investors Services; Standard & Poor's.



level of rating provided by one of the agencies recognized by the CNMV (for the time being, Fitch Ratings; Moody's Investors Services and Standard & Poor's).

Italy

113. In Italy there is specific legislation and rules concerning credit rating in operations of securitization. In particular, Law 130 of 30 April 1999 – concerning “Provisions on credit securitization” – requires (art. 2, par. 5) that Consob establishes the professional qualifications and criteria to ensure the independence of the entities that carry out the credit rating of securitization operations. The Law also requires the disclosure of information concerning any relationship between the rating agency and the persons who, in their respective capacities, are party to the transaction.
114. These requirements and criteria should be fulfilled either where a credit rating issued by qualified third parties is required (the Law 130 provides that the rating is required where the securities relating to the securitisation transaction are offered to persons other than professional investors) or where the rating is not required but it is anyway issued, with regard to the securitisation transaction.
115. Consob, by way of its own Regulation n.12175 of 2 November 1999, established (art. 2) professional requirements covering the following:
 - Credit rating agencies should be constituted as a company or a partnership;
 - persons which contribute to the elaboration of the credit rating should have an experience in this activity of at least three years, in managerial functions; and
 - credit rating agencies should adopt evaluation procedures predetermined and conforming upon international standards and use appropriate technical support and staff.
116. Consob stated that these requirements are considered fulfilled by credit rating agencies operating in the markets of the EU for at least three years.
117. Moreover, Consob established (art. 3) independence criteria for entities that carry out the credit rating with respect to other entities which are party to the rating transaction, and stated that the prospectus of the securitisation transaction should contain indications on shareholdings (if any) of the credit rating agency (or its controlled or controlling entities) in the capital of other parties to the transaction (or its controlled or controlling entities), and vice versa.

C) ANALYSIS OF THE MAIN ASPECTS RELATING TO THE ROLE OF CRAS IN STRUCTURED FINANCE

i) Transparency

Characteristics and limitation of ratings

118. As highlighted in the consultation paper, ratings play a key role in the decision making process of investors when assessing the appropriateness of a structured finance product against their investment criteria, probably more so than with other assets due to the greater complexity of these products and, generally, less access to public information than some other products.
119. Ratings are designed to evaluate a specific element of credit risk associated with holding an asset (for example probability of default) and are not designed to be used as a proxy for pricing, liquidity or other elements of market risk. It appears that due to the complexity of structured finance products investors became over-reliant on credit ratings and also used them for purposes for which they were not intended.
120. Although it is the investors' responsibility to ensure their risk analysis and investment decision making process is robust and thorough, it is not clear to CESR whether the CRAs made real efforts to highlight the limitations of their ratings of structured finance products to market participants. Although all the CRAs make use of disclaimers to highlight the nature of their ratings of



structured finance products these are not always given much prominence on the rating opinions. Concerns have been raised that even if the CRAs did not deliberately mislead investors over the meaning and limitations of their ratings they did not act to correct developing misconceptions. CESR notes that there has been some improvement in the level of CRA communications with the market on this issue recently.

121. In the consultation paper, CESR highlighted the need for the CRAs to take appropriate action on an on-going basis to ensure that they communicate clearly the central characteristics and limitations of their rating of structured finance products. CESR asked market participants for views on this issue.

Summary of responses

122. The responses to this question are unanimous in their agreement that action should be taken on an on-going basis by the CRAs to communicate central characteristics and limitations of their ratings of structured finance products. The need for prominent disclosure of the limitations of these ratings was highlighted. At the same time, three of the respondents noted that their members, professional investors, understand already that a rating of a structured finance product has certain limits. A number of replies indicated that this effort on the part of the CRAs should not be limited to a statement or extensive disclaimer, but that it should be done on an ongoing basis keeping in mind the need for clarity and ease of access. A number of replies referred in particular to the need to improve the navigability of the websites of the CRAs. One reply specifically supported the notion of a separate rating scale for structured finance products, while another one specifically indicated that it was against the creation of a separate scale.

123. Five agencies, replying jointly, acknowledged that although they have regularly communicated information, more can be done and they offered an example of what kind of statement could be made.

124. CESR highlights the need for CRAs to take appropriate action on an on-going basis to ensure that they communicate clearly regarding the characteristics and the limitations of the ratings of structured finance products. This effort should not be limited to a disclaimer statement, even an extensive one. CESR suggests that the agencies keep in mind that while many professional investors already have an understanding of these limitations other may not, furthermore, some may need to educate their underlying clients.

Transparency of methodology and individual ratings

125. During the course of its information gathering, CESR found that a major concern was the ability of investors to determine key model assumptions, for example default correlations or expected housing price appreciation for RMBS, used within structured finance methodologies and their relative impact on the rating. Whilst some of the CRAs indicated that they were introducing services to assist investors in assessing the impact of various assumptions on their ratings, these would not be freely available.

126. Although the CRAs make their methodologies available, an understanding of the key underpinning assumptions, such as the estimated correlation of obligors in the asset pool or the cross-correlations, would greatly assist investors in assessing whether the rating is based on expectations that are in line with their own. One of the distinctive characteristics of structured products is the fact that changes to these assumptions and the related correlations have an impact on the rating that can be greatly magnified. Whilst CESR recognises that the CRAs' models and methodologies are one of their key competitive features, greater transparency of key model assumptions would improve investor ability to properly use ratings when performing their due diligence and improve their confidence in them. It would be regrettable if the CRAs developed this as a separate service.



127. Independent of the pure transparency aspects, concerns have been raised about the relevancy of the methodologies currently used for structured products. The issues raised concern the concept of the average probability of default under “normal” circumstances and the need for complementary approaches based on stress testing, taking into account the fat tails of the distribution curve of risks.
128. In the consultation paper, CESR recommended that CRAs reconsider their approach to publishing methodologies to give investors access to information on key model assumptions when using ratings in their investment decisions. CESR also suggested that the potential impact that changes to these assumptions and correlations have on the ratings themselves should be highlighted.
129. CESR stated that it believed that the provision of information on the weightings of key parameters and correlations underlying structured finance ratings would assist investors in making informed use of these ratings in their risk assessment procedures. Information on the level of stress testing carried out during the rating process, to address concerns over tail risks would also allow investors to make better use of structured finance ratings in their investment decisions.
130. CESR then asked market participants if they agreed with the view that although there has been improvement in transparency of methodologies, further improvement is needed in particular regarding the accessibility and content of this information for complex structured finance products, so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings.

Summary of responses

131. The respondents to this question all agreed that although information on the methodologies used may be available further improvement is needed with regards to key model assumptions and the weightings of parameters and correlations underlying them. In addition, the need to provide information regarding the impact of changes to the assumptions and correlations was highlighted. One respondent indicated that the CRAs rely heavily on statistical analysis but do not disclose its limitations. Another was in favour of differentiating the nomenclature used for the ratings of structure finance products.
132. Regarding accessibility to the CRAs’ websites, one reply suggested that the agencies remove the registration feature from their sites.
133. The joint response from five CRAs indicated on the one hand that they will each consider what changes might appropriately be made to their websites to facilitate access to important information. On the other hand, they do not appear to agree that the specific information referred to in the consultation paper should be provided.

134. CESR stresses the need for CRAs to provide information on critical model assumptions, in particular, the weightings of key parameters and correlations underlying structured finance ratings. 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.

Changes in methodology

135. The CRAs indicate that they review their methodologies on a regular basis, either on a yearly basis or in the event that the performance is outside of expected parameters for a particular asset class.



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.
138. In the consultation paper CESR suggested that CRAs should highlight clearly to investors which particular methodology a rating for a structured finance product is based on. One way in which this could be achieved is a clear labelling of ratings to indicate against which version of a methodology they were based on, including a link to the specific model.
139. Furthermore, CESR suggested that CRAs should be clear as to whether a change in methodology or performance in underlying asset pools has led to a rating review and asked market participants on their views to these issues.

Summary of responses

140. According to some commentators, as the massive downgrades which occurred in July, August and October coincided with the announcement of changes to rating methodology, it was not clear to investors if the downgrades resulted from the changes to methodologies or to the credit quality of the underlying assets, or both.
141. Almost all participants agree that there needs for greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as rating reviews.
142. Most participants feel that labelling of changed ratings is essential. First, changes in methodology should be flagged to identify the correct version of methodology a rating is based on. Furthermore, including a link to the related model and assumptions was supported by some market participants. Second, it should be easily identifiable whether a rating action is based on changes in methodology or on the quality of the underlying assets.
143. The establishment of a mechanism or process that would ensure independent review of methodologies, models and internal governance processes of rating agencies was seen as a useful approach by one participant.
144. Even CRAs agreed in a joint statement that enhanced disclosure with regard to methodologies could be helpful.

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| <ol style="list-style-type: none">145. Disclosure of changes in assumptions and methodologies are essential pieces of information containing valuable information to market participants in order to enhance their credit assessments.146. Therefore, CRAs should highlight clearly to investors which particular methodology a rating for a structured finance product is based on. For example, labelling ratings to clearly indicate against which version of a methodology they were based on, including a link to the specific model. Furthermore, CRAs should be clear as to whether a change in methodology or performance in underlying asset has led to a rating review. |
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Standardised public disclosure

147. There is often very little public data available on the performance of the underlying assets in structured finance products, this combined with the often heterogeneous nature of these products makes comparable assessment of these products by investors more problematic. Some organisations within the EU have highlighted initiatives they have begun to improve the level of



standardisation and public disclosure of data for securitised products which CESR views as a positive step.

148. In the consultation paper, CESR highlighted the issue that a greater level of public and standardised information should be generated to aid market participants in reaching their investment decisions. All in all, this would be a great deal of benefit to the market.

Summary of responses

149. Most market participants agree that there needs to be greater public and standardised information on structured products in the EU. They state that this will improve investors possibility regarding interpretation and analysis of data.

150. A great number of respondents refer to the European Securitization Forum's (ESF) submission to the European Commission as a suitable mean regarding the standardisation of data. One market participant demands the construction of a public available independent data base in order to collect and consolidate available data. However, some market participants also remark that standardisation has its limit due to a higher grade of complexity and the differences between the transactions. In this context, one market participant demands a constrain on CRAs in receiving non-public information based on the argumentation that either information is crucial for risk assessment and thus should be publicly available or is not and thus should not be made available to CRAs.

151. CRAs, as well, support suggestions in order to enhance standardized information and reduce opacity in structured finance transactions due to limitations in performance reports. Further on, they demand from issuer's side comprehensive disclosure in a standardized manner about the characteristics of each asset in the asset pool, the validation process used to verify the quality of information provided and all pertinent representations and warranties as well as servicer and trustee reports.

- 152. A great deal of benefit to the market could be achieved if a greater level of public and standardised information is generated in order to support market participants in reaching their investment decisions. This information would allow investors to carry out more appropriate risk assessment of these products. CESR recommends that the Commission considers how best to facilitate the increased disclosure of this information to the market by issuers.**

ii) Human resources

153. Concerns have been raised that the level of staffing, both in terms of numbers and experience, at the CRAs was inadequate to effectively and accurately rate the volume and complexity of structured finance deals that warranted review in the second half of 2007. There is also concern that staff turnover was particularly high leading to ratings being assigned to inexperienced analysts. The lack of comparability of human resources information provided to CESR by the CRAs and the inability of the CRAs to provide this information in the granularity that CESR requested has made it hard to draw detailed conclusions on the level of staff resource and experience growth over recent years. The same can also be said for the figures provided on staff turnover.

154. Furthermore, looking at the evolution of educational and professional experience requirements, it is noticeable that most agencies indicate that they have not changed their educational and experience level requirements over the past 10 years despite the increased sophistication of structured finance products and the growing importance of complex quantitative models in the credit assessment of those products. Only one agency points to the increased need for recruiting quantitative experts (financial engineers, statisticians, etc.) in the structured finance area.

155. The provisions of ratings by committees instead of individual analysts implies there is an inherent check on the quality of the rating by other staff, including a senior and experienced



employee. However, as mentioned above, concerns have been raised over the CRAs ability to retain sufficient numbers of experienced staff to maintain the quality of ratings. Currently there is very little public disclosure by the CRAs on this aspect of their organisation. Moreover, concerns have been raised regarding the remuneration criteria for structured finance analysts. Although replies to the questionnaire sent to the CRAs indicated that analysts are compensated on the basis of their qualitative performance, the importance of a given client to a CRA is clearly known by staff members and may influence the rating process.

156. In the consultation paper, CESR indicated that it is understandable that the CRAs will not follow the same method of resource monitoring and will have their own internal staff seniority scales. Nevertheless, CESR highlighted its concern about the inability of the CRAs to provide information that would allow a more detailed analysis of their staffing trends, especially given the importance of human capital to their business model. CESR would expect that rating agencies should have sufficiently advanced human resource management processes that they are in a position to provide key trends in staffing, employee development and turnover levels. The fact that they did not provide this information is an area of concern.
157. As regards the generally unaltered educational and professional requirements of CRAs' recruitment policies, CESR raised the question whether this could negatively impact the quality of the rating process, given the rising complexity of structured finance products. Furthermore, CESR suggested in its consultation paper that the CRAs should consider the correct approach to ensuring the market has confidence that they are adequately resourced to provide accurate and high quality ratings. CESR indicated that this might be achieved via a greater level of transparency over their levels of human resource. Finally, CESR would welcome more clarity about the remuneration policies for staff members involved in the rating process and would welcome measures taken to render remuneration decisions as independent as possible from influence.
158. CESR asked market participants' views about these concerns and also whether participants believe CRAs have maintained sufficient human resource, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business.

Summary of responses

159. Most respondents agree that adequate qualification and number of rating analysts are essential for the high quality of ratings. Many respondents expressed doubts as to whether CRAs have maintained sufficient human resources and especially pointed to the area of ratings monitoring as lacking sufficient resources, both in terms of number of analysts and qualification. Respondents also identify the high turnover of staff in CRAs as one of their main concerns.
160. As regards recruitment policies by CRAs, a few respondents express their doubts about the generally unaltered recruitment policies while others note that imposing specific educational and professional requirements would not contribute to the quality of ratings. Yet, some respondents mentioned concerns about the excessive reliance on quantitative models and the need for a more qualitative input in ratings, such as by macroeconomic analysts.
161. Only a few respondents share CESR's concerns about the inability of CRAs to provide adequate human resources information whereas others argue that the overriding interest is the quality and timeliness of the ratings. Although some participants would welcome more transparency of CRAs' human resources, there appears to be no strong view that this may alleviate current concerns on the quality of ratings. Some participants rather point to improved transparency on CRAs' internal structure and decision making process.
162. Finally, most respondents agree that credit analysts' remuneration policies of should solely be linked to quality criteria and managed so as to eliminate potential conflicts of interest. Some respondents support public disclosure of remuneration policies but others express doubts on this proposal.



163. CESR expects that rating agencies should have sufficiently advanced human resource management processes that they are in a position to provide key trends in staffing, employee development and turnover levels.
164. In addition, CESR urges CRAs to ensure that IOSCO Code provisions 1.4 and 1.7 are, in practice, uniformly applied to initial credit rating and monitoring of existing ratings. These principles require CRAs to “(...) *use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied*”, and state that CRA “(...) *should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, (...)*”.
165. CESR also highlights the need for CRAs to improve disclosure of selective human resources indicators that would contribute to increase market confidence that CRAs are adequately resourced to provide accurate and high quality ratings, and to design analysts' remuneration policies in such way as to prevent potential conflict of interests and guarantee analyst's independence. At the same time, CESR concurs with respondents that there is no need of imposing specific educational and professional requirements.

iii) Monitoring of ratings

Use of monitoring timetables

166. Monitoring timetables for structured finance products, such as RMBS, are typically driven by the regularity at which data is received on the underlying collateral pools – typically monthly or quarterly. This data is assessed automatically for each monitored transaction to check that predefined performance triggers have not been breached. In the event that these triggers are breached the rating is put under formal review. Ratings are also subject to a formal annual review.
167. CESR has been asked to comment on the value of CRAs producing periodic public reviews of structured finance ratings to some contractual deadline. This would likely have significant cost implications for the market as the cost of maintaining these ratings will increase. These public reviews would also lead to a large increase in the volume of information being published by the CRAs, which might add a little value in terms of individual product transparency but would likely prove detrimental to overall transparency.
168. Given the nature of the automatic monitoring already carried out on structured finance products, CESR noted in its consultation paper that having contractually determined public reviews would not add value to the monitoring process. CESR asked markets participants whether they agreed with this view.

Summary of responses

169. All respondents to the survey agreed that contractually determined public reviews would not add value to the monitoring process. Some respondents noted that monitoring should not only mean data monitoring but also monitoring of macro economic expectations. In other words, the agencies should take a more proactive approach to monitoring by assessing the impact on ratings of possible future macro economic developments.

170. CESR advises against contractually set public reviews for individual structured finance ratings as this could have a negative impact on the overall market transparency.
171. CESR highlights the need for agencies to dedicate sufficient resource to their monitoring functions. CRAs should also ensure that their rating methodologies are reviewed sufficiently often.

Assignment of resources to the monitoring process



172. Typically, on an on-going basis fewer resources are dedicated to monitoring ratings than to carrying out initial ratings for two key reasons. Firstly, as indicated above, much of the initial monitoring of these transactions is carried out automatically against data performance criteria. Deals will be assigned for specific review by an analyst only if they do not perform as expected. The number of transactions a surveillance analyst is assigned will also depend on the asset class and complexity of the transactions being monitored. Secondly, as the analytical work on the particular deal structure and legal framework has already been carried out, the rating review work should prove to take less analyst time.
173. The nature of structured finance products means that a deterioration in credit quality across an asset class can lead to a large number of ratings requiring review within a short period of time, with the possibility of further impact on products that are another stage along the securitisation chain from the underlying asset (CDOs of RMBS for example). This means that the resource required to process rating reviews may spike, with much greater staff and processing time required at certain periods to allow for rating reviews to be completed in a timely manner.
174. In the event that a CRA determines that an asset class is behaving outside of expectations they will review their methodology, reassessing specific ratings, or groups of ratings, where they evaluate the underlying assets are performing outside initial expectations. This can place a significant strain on analyst and committee resources in terms of processing a large number of rating reviews concurrently.
175. Although the CRAs have made concerted efforts to increase their resourcing for the surveillance of structured finance transactions since last summer, including the establishment of specific monitoring teams for certain assets and products, they had traditionally not allocated specific resource to this activity for some asset classes of structured finance business.
176. In their responses to CESR's questions the CRAs indicated that there was no conflict for analysts and committee resource between that dedicated to new issuances and that focused on reviewing ratings – either against new methodologies or due to a decline in asset performance. CESR remains concerned about the ability of CRAs to react appropriately to widespread credit deterioration in particular asset class performance which requires them to review large numbers of ratings in a short time period.
177. In the consultation paper CESR indicated that it supported the establishment of individual monitoring teams for structured finance products but recommended that the CRAs continue to evaluate their internal processes to ensure they maintain the operational flexibility to allow them to dedicate necessary resource to reviewing outstanding ratings, when necessary, to ensure timely action is taken. CESR asked market participants whether they agree that the monitoring of structured finance products should be a specific area of oversight going forward. CESR also asked whether there were any particular steps that CRAs should take to ensure the timely monitoring of complex transactions.

Summary of responses

178. All respondents agreed that the monitoring of structured finance products presented a significant challenge. A large majority also supported the assignment of different teams to the initial rating process and the monitoring of existing ratings. A few asset manager representatives stressed that investors should get access to more regular information, especially the issuer report or trustee reports which the CRAs receive, and that monitoring data should be freely available to investors. A few asset managers noted that they did not support the monitoring of methodologies.

179. CESR recommends that the CRAs continue to evaluate their internal processes to ensure they maintain the operational flexibility to allow them to dedicate resource to reviewing outstanding ratings where necessary, to ensure punctual action is taken. This is a particular area of concern for CESR and will be under greater focus in the future.

iv) Conflicts of interest



Interaction with issuers/arrangers

180. The nature of structured finance means that the rating process tends to involve a more iterative interaction between the CRAs and the issuer/arranger. One reason for this is that issuers of structured finance have more flexibility to alter the composition of their security than a corporate issuer would have to amend their finances. The CRAs highlighted that this interaction is beneficial in allowing them to gain a clear understanding of the proposed structure of the deal and produce a better informed rating. However, accusations have been levelled against the CRAs that their interaction with issuers/arrangers has become advisory in nature and presents a heightened risk that conflicts of interest will negatively impact the objectiveness of their rating opinions.
181. The CRAs indicated to CESR that they do not view their interaction with issuers/arrangers of structured finance products as advisory in nature. Typically, the issuer/arranger will bring a proposed structure to the CRA and the CRA will carry out its modelling and assessment of the underlying asset pool(s). This assessment will highlight the relative strengths and weaknesses of the structure, asset pool(s) and credit enhancement levels of the proposed product as well as providing an indicative rating. The issuer/arranger can then accept the initial rating proposed as a result of this assessment or choose to restructure the product in a number of ways to improve this rating. The CRAs stated that the way this is achieved, for example by altering the underlying asset pool(s) or improving credit enhancement levels is left to the issuer/arranger and the CRA will perform a new assessment on any amended structure.
182. The CRAs indicated to CESR that they may provide feedback on credit enhancement levels, but only in-line with their publicly available methodologies and they did not provide advice on how to structure any deals. They do not therefore consider they provide an advisory service or believe their activity creates additional unmanageable conflicts of interest.
183. In the consultation paper, CESR indicated that CRAs should ensure that they are fully transparent with regard to the exact nature of their interaction with issuers/arrangers of structured finance products. They should also have strong policies and procedures in place to monitor and control this interaction and ensure it reflects their public position. CESR asked market participants whether they believe that the level of interaction between the CRAs and issuers of structured finance products creates additional conflicts of interest for the CRAs to those outlined above. CESR also asked market participants whether they believe that any of these conflicts are not being managed properly.

Summary of responses

184. Most respondents agreed that the high level of interaction between CRAs and issuers of structured finance products is necessary because of the nature of the rating process. At the same time, the large majority of respondents acknowledged that this situation creates opportunities for conflicts of interest. A significant number of respondents – especially asset managers’ and analysts’ representatives – felt that conflicts of interest are already present in structured finance ratings.
185. Most respondents agreed that these conflicts of interest should be appropriately managed by CRAs through detailed and rigorous policies and procedures. A couple of respondents proposed imposing conduct of business regulations to deal with these conflicts of interest. Generally respondents did not indicate if they believe that these conflicts are managed properly. A few respondents noted that these conflicts were well managed and a few others noted that they had no opinion.

186. CESR recommends that CRAs ensure that they are fully transparent 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 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.



Disclosure regarding the nature of interaction

187. In the consultation paper, CESR explained that it felt that a clearer consensus over what constitutes advisory activity in the structured finance rating process would be beneficial to the market, because this would clarify market and regulatory expectations. Moreover, CESR indicated that it would suggest that the IOSCO Code be updated to provide greater clarity and act as a benchmark of acceptable practices for CRAs' interaction with issuers of structured finance products. CESR asked market participants whether they agreed that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers in the structure finance rating process and that there needs to be clearer definitions of acceptable practice.

Summary of responses

188. The large majority of respondents agreed that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers in the structured finance rating process and that there should be a clearer definition of acceptable practices. This would ensure that this interaction is well managed and provide investors with minimum standards with which the CRAs must comply.

189. Most respondents also supported the view that the definition of acceptable practices should be carried out in the context of the review of the IOSCO Code of Conduct. Some respondents noted that there needed to be more stringent rules with respect to conflicts of interest, either introducing some kind of regulation or having a commitment by CRAs to implement all parts of the IOSCO Code, and that regulators should ensure effective monitoring of compliance.

190. CESR believes that a consensus over what constitutes advisory activity in the structured finance rating process would be beneficial to the market as this would clarify market and regulatory expectations. CESR notes that IOSCO has proposed a new measure to its Code that, if confirmed, would establish that CRA analysts may not make proposals or recommendations on structured finance products that the agency rates. In this context, CESR suggest that IOSCO refines this concept by introducing a clear definition of what advisory business is. This definition should act as a benchmark of acceptable practices for CRAs' interaction with issuers of structured finance products.

Definition of ancillary services

191. The IOSCO Code requires that the CRAs separate their credit rating business and analysts from any other business, including consulting business, which may present a conflict of interest. This has led to some issues due to the lack of a definition of ancillary business and more particularly whether activities such as 'rating assessment services', 'pricing services' or other credit evaluation services, are ancillary or core rating activities. In its February 2007 consultation report IOSCO indicated that provision 1.14 of the Code explicitly contemplates CRAs providing such rating assessment type services, and explicitly contemplates that such services might typically fall under the ambit of a CRAs analytical staff.

192. CESR has, so far, been unable to completely satisfy itself over the segregation of rating and ancillary business at the CRAs due to the lack of a clear definition of what an ancillary business is. An important consideration here is the level of disclosure by the CRAs, as typically they have also no public definition of what constitutes an ancillary service in their organisation. The importance of this issue should not be underestimated in light of the questions that have arisen in the context of recent events related to asset valuation.

193. In the consultation paper, CESR indicated that there needed to be greater clarity from the CRAs over what they consider to be ancillary business and what they consider core rating services. CESR also noted that the CRAs have not properly segregated or disclosed all services that pose a conflict of interest to their rating services. Accordingly, CESR asked market participants whether they believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business.



Summary of responses

194. The large majority of respondents agreed that there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business. This would allow market participants to be in a position to assess how the agencies deal with this issue. A few asset managers indicated that a clear definition – to be agreed and standardised across the industry – should be identified by a joint contribution of regulators, CRAs and other market participants. Other respondents noted that the definition should be possible to interpret in a flexible fashion.

195. CESR believes that there needs to be greater clarity over what constitutes ancillary business and what constitutes core rating services as there are concerns that the CRAs have not properly segregated or disclosed all services that pose a conflict of interest to their rating services which must be addressed. CESR requests IOSCO to introduce a definition of ancillary business and core rating services in the Code.

Structured finance fee structure

196. The fee structures for structured finance products differ from traditional corporate fees and may become substantially larger depending on how complex and innovative the product is. The general structure for structured finance fees is to calculate a transaction fee determined as a percentage of the total issuance value (often with floors and ceilings), based on the anticipated complexity of the deal and the asset class of the product. Moreover, in case of complex and innovative structured finance transaction rating which require substantial additional time of analysis, fees can result higher than initially envisaged. This is then further increased by adding a fee for monitoring the transaction through its lifetime, either to be paid upfront or an agreed annual fee. The fees for structured products thus increase with the size and frequency of the issues rated. These transaction based fees are in fact ‘success fees’, as they are charged only if the deal goes through.

197. The CRAs highlighted that the increment in fees due to additional complexity of deals reflects the greater resource and time required to rate these products.

198. In its consultation paper, CESR noted that the fee model for structured products was transaction based and dependent upon the completion of the rating process and that this could create a conflict of interest. CESR asked market participants whether they thought the fee model created a conflict of interest and, if they thought it was the case, how well the CRAs managed this conflict of interest.

Summary of responses

199. Market responses to the CESR survey on structured finance indicate that participants were mostly satisfied with the level of fee disclosure in general but that there could be greater disclosure of structured finance fees. Respondents also highlighted the difficulty in comparing fee structures due to the complexity of deals and heterogeneous nature of the products.

200. Most respondents agreed that the fee model structure created a conflict of interest. However, a number of them also noted that it was difficult to see a viable alternative fee model. A substantive number of respondents felt that there was no conflict of interest or that it was not different than with a corporate rating. Markets participants generally felt that they were not able to comment on how well the conflicts were managed.

201. CESR believes that there is the potential for the fee structure to create a conflict of interest. Greater disclosure of fees received from individual firms might assist in alleviating concerns held by some market participants over the conflicts posed by repeated business of CRAs with one issuer. IOSCO has proposed in their report for consultation a provision aimed at addressing this issue. However, even though market participants have not expressed any distinct opinions on this issue, CESR suggests that IOSCO considers a more granular measure for addressing this issue in its provisions.

Disclosure regarding break-up fees and concerns regarding “rating shopping”

202. CESR notes that public disclosure surrounding 'break-up' fees, when an arranger is charged for analytical work done by the CRA even if they choose not to proceed with the rating, is not always made by the CRAs.
203. It has been highlighted to CESR that there is a possible risk of 'rating-shopping' related to structured finance products. Issuers can take the same, or similar, product to a number of agencies to gain the highest rating possible for the quality of underlying assets in the pool. Issuers are able to tailor structured products to the CRAs publicly available models and there is no requirement to proceed with a final public rating. The combination of these factors could present commercial pressures for the CRAs to rate these structures favourably to their peers which needs to be well managed by the CRAs.

Summary of responses

204. The large majority of respondents supported greater disclosure of the fee composition, including break up fees. A few respondents saw little value in disclosing break up fees.

205. CESR believes that the market would benefit from greater transparency around 'failed' or non-issued ratings, including break-up fees. CESR is of the opinion that improved transparency in this area would help alleviate market concerns over the integrity of the rating process in structured finance products, in particular over the risk of 'rating-shopping.'

206. CESR supports IOSCO's efforts in its consultation paper to revise the Code of Conduct in order to require further disclosure by CRAs of situations where issuers do not proceed with a rating based on an initial opinion (provision 2.8.c). However, even though not explicitly mentioned previously in the consultation paper, CESR has concerns that this provision might be not workable in practice and should be reconsidered. For example, in some cases with slight variations within the product design or the asset pool a 'different' product could be created, effectively making any disclosure by CRAs of non-finalised/issued ratings on these products of little value in assuring investors that the issuer has not been 'rating-shopping'.



IV. ANALYSIS OF THE CHANGES OF THE CRAS CODES IN RELATION TO IOSCO CODE

207. In this section CESR is providing in a columnar format a comparison of the latest available codes of the CRAs with the IOSCO Code of 2004. The analysis in this section will focus on the areas identified in CESR's first report published in December 2006 as being not fully compliant with the original Code and where CESR still sees room for improvement.

208. Row I of the table gathers the old and new version of the different provisions of the codes of relevant CRAs in a user-friendly way to allow a quick comparison with the relevant measures of the IOSCO code.

209. Row II collects the explanations given by the CRAs as to why for that specific provision they have opted to "explain rather than comply with" and may include indications of how the provision is being applied in practice. Furthermore, rationale for CESR's conclusion is given in this row.

210. To ease the understanding of this section a summary table is provided below.

DBRS		FITCH		MOODY'S		S&P	
OLD	NEW	OLD	NEW	OLD	NEW	OLD	NEW
1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
1.11	1.11	1.11	1.11	1.11	1.11	1.11	1.11
1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.12
1.13	1.13	1.13	1.13	1.13	1.13	1.13	1.13
1.14	1.14	1.14	1.14	1.14	1.14	1.14	1.14
1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.15
1.16	1.16	1.16	1.16	1.16	1.16	1.16	1.16
2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10
2.11	2.11	2.11	2.11	2.11	2.11	2.11	2.11
2.12	2.12	2.12	2.12	2.12	2.12	2.12	2.12
2.13	2.13	2.13	2.13	2.13	2.13	2.13	2.13
2.14	2.14	2.14	2.14	2.14	2.14	2.14	2.14
2.15	2.15	2.15	2.15	2.15	2.15	2.15	2.15
2.16	2.16	2.16	2.16	2.16	2.16	2.16	2.16
3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1
3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4



3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
3.10	3.10	3.10	3.10	3.10	3.10	3.10	3.10
3.11	3.11	3.11	3.11	3.11	3.11	3.11	3.11
3.12	3.12	3.12	3.12	3.12	3.12	3.12	3.12
3.13	3.13	3.13	3.13	3.13	3.13	3.13	3.13
3.14	3.14	3.14	3.14	3.14	3.14	3.14	3.14
3.15	3.15	3.15	3.15	3.15	3.15	3.15	3.15
3.16	3.16	3.16	3.16	3.16	3.16	3.16	3.16
3.17	3.17	3.17	3.17	3.17	3.17	3.17	3.17
3.18	3.18	3.18	3.18	3.18	3.18	3.18	3.18
4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2

1.15	IOSCO Code	S&P Code (old)	S&P Code (new)
I	The CRA should institute policies and procedures that clearly specify a person responsible for the CRA's and the CRA's employees' compliance with the provisions of the CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of the CRA's rating operations.	The Executive Vice President in charge of Ratings Services shall have overall responsibility for the design and implementation of, and compliance with, this Code and the related policies and procedures and also compliance with any laws applicable to Ratings Services.	The Ratings Service Chief Compliance Officer shall be responsible for reviewing Ratings Services' and Ratings Services' employees' compliance with the provisions of his Code and with applicable laws and regulations. In fulfilling this role, the Chief Compliance Officer is assisted by others in the Global Regulatory Affairs Department and personnel in Ratings Services responsible for analytical quality, criteria and policymaking. The reporting lines and compensation of the Chief Compliance Officer and the Global Regulatory Affairs Department shall be independent of Ratings Services' rating operations.
II		S&P has removed the old contradicting wording of provision 1.15. Now a CCO is responsible for the CRA's and the CRA's employees' compliance with the provisions of Ratings Service's Code of Conduct. This new provision 1.15 of S&P's Code of Conduct can be considered as an adequate implementation of provision 1.15 of the IOSCO Code. CESR considers this provision as compliant with the IOSCO Code.	
2.5	IOSCO CODE	DBRS Code (old)	DBRS Code (new)



<p>I</p>	<p>The CRA, should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.</p>	<p>DBRS's only business is related to ratings. DBRS does not engage in ancillary businesses, including consulting or advisory services that may present a conflict of interest. DBRS has in place appropriate policies and procedures to manage its ratings business on a global basis.</p>	<p>DBRS is in the ratings business. DBRS does not engage in ancillary businesses, including a consulting or advisory business that may present a conflict of interest. Although DBRS may provide an Impact Assessment at an Issuer's request, DBRS views this work as an extension of its existing relationship with the Issuer and not as a separate business line. DBRS uses its standard ratings process, methodologies and policies in formulation such Impact Assessments. DBRS has implemented appropriate policies and procedures to manage its ratings business on a global basis.</p>
<p>II</p>		<p>DBRS reformulated provision 2.5 of its Code of Conduct. Now, in DBRS's new version of provision 2.5, the agency explains their definition of an Impact Assessment and states that common internal policies and procedures apply to the Impact Assessment as well. DBRS still classifies its Impact Assessment Service as an extension to its regular ratings service which is available to customers on request. DBRS explains that "there is a valuable consistency in having all considerations with an issuer performed by the same analyst team". DBRS has chosen to explain the current situation in this way in order to comply with the IOSCO Code.</p> <p>DBRS defines an ancillary business or service to be those products and services that are related to, but not necessarily derived from the credit rating process. Nor does DBRS provide consulting or advisory services to issuers they rate.</p> <p>DBRS regards an impact assessment as a fundamental part of the Corporate Finance rating process and relationship and not as an ancillary business. Where a rated issuer asks DBRS how a potential specific transaction or event would impact its rating, DBRS may provide feedback on likely rating movements based on the proposed scenario and other factors that could have an impact on the issuer's rating(s) in the form of an "impact assessment".</p> <p>Impact assessment work arises where there is a need for more formal evaluation than the typical ongoing discussion between the issuer and analysts in the normal discourse of the relationship. DBRS does not consider that this creates a conflict of interest which would undermine the objectivity of the credit rating. DBRS may charge a fee for impact assessment and DBRS procedures address how and when any such fee would be imposed.</p>	



		<p>DBRS does not believe there is any potential for conflicts of interest in using the same analyst team in these circumstances. Where there is a need to use separate teams for two rated issuers, DBRS will do so. DBRS follows the same rating process, methodologies and policies that are applied to any of DBRS credit ratings including a determination by rating committee. In addition, impact assessments arise infrequently. DBRS size makes it impractical to create a separate business unit for this purpose.</p> <p>Although DBRS provides an explanation as to how they seek to achieve the goals of provision 2.5 CESR would define rating impact assessment services as an ancillary service and thus</p> <p>CESR considers this provision as not compliant with the IOSCO Code.</p>	
2.5	IOSCO CODE	Fitch Ratings Code (old)	Fitch Ratings Code (actual)
I	<p>The CRA, should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.</p>	<p>Fitch shall separate, both operationally and legally, its rating business and analysts from any of its other businesses that may present a conflict of interest.</p> <p>Fitch shall maintain and publish a formal Firewall Policy governing firewalls and operations between Fitch and its non-rating affiliates to mitigate potential conflicts of interest. This policy is available on Fitch's free public website, www.fitchratings.com, on the homepage, under the link "Code of Conduct".</p>	<p>No changes have been made; the Code of conduct remains that dated April 2005.</p>
II		<p>In their letter to CESR dated May 10, 2007, Fitch Ratings indicates that they do not find it necessary to revise their Code with regard to this point and do not regard the operation of Valuspread (CDS Pricing Services) or the rating assessment service as exceptions to the IOSCO Code. This is because they do not consider that the rating assessment service is an ancillary but rather an integral part of their business.</p> <p>As of beginning of 2008 Fitch announced it was restructuring its operations to create a new division, Fitch Solutions integrating its CDS Pricing Services and other ancillary services into this newly formed division.</p> <p>Although Fitch provides an explanation as to how they seek to achieve</p>	



		<p>the goals of provision 2.5 CESR considers rating impact assessment services still form part of Fitch Ratings' business. CESR considers this activity to be an ancillary service and thus</p> <p>CESR considers this provision as not compliant with the IOSCO Code</p>	
2.5	IOSCO CODE	Moody's Code (old)	Moody's Code (new)
I	<p>The CRA, should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.</p>	<p>Moody's will separate its Credit Rating business and Analysts from other businesses that may reasonably present a conflict of interest, as described in Moody's Policy with Respect to Non-Rating Services. Rating committee members may neither sell nor provide such services to rated Issuers. Moody's will ensure that any existing or future ancillary business operations that do not necessarily present conflicts of interest with the Moody's Credit Rating business have in place procedures and mechanisms, to minimize the likelihood that conflicts of interest will arise.</p>	<p>MIS will separate, operationally and legally, its Credit Rating Services and Analysts from any other businesses, including Non-Rating Services and consulting businesses, that may present a conflict of interest. For Ancillary Services that do not necessarily present conflicts of interest with MIS's Credit Rating Services, MIS will have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise, or to appropriately manage those conflicts that may arise.</p>
II		<p>Moody's 2005 Code includes a footnote stating: <i>"Moody's considers its Rating Assessment Service to be an integral element of the rating process that provides Issuers with the likely rating impact of contemplated corporate actions and as such, contributes to rating predictability and reduces market volatility. As such Moody's does not consider it a non-Credit Rating service."</i></p>	<p>The new wording makes an important distinction from the previous one as it states that the Credit Rating services and analysts will be separated in operational and legal terms from other businesses which may present a conflict of interest. Nonetheless, it includes ancillary services in with credit rating services instead of separating them as the IOSCO Code indicates. Furthermore, in its "Policy With Respect to Non Ratings Services", Moody's indicates that <i>"The Rating Assessment Service in an integral part of the rating process that provides issuers with the likely rating impact of contemplated corporate actions and as such, contributes to rating predictability and reduces market volatility. As such Moody's does not consider it a</i></p>



			<p><i>non-Credit Rating service.”</i></p> <p>Although MIS provides an explanation as to how they seek to achieve the goals of provision 2.5 CESR would define the Rating Assessment Service as an ancillary service and thus</p> <p>CESR considers this provision as still not compliant with the IOSCO Code.</p>
2.5	IOSCO CODE	S&P Code (old)	S&P Code (new)
I	<p>The CRA, should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.</p>	<p>Rating Services shall ensure that ancillary business operations which do not necessarily present conflicts of interest with Ratings Services' rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise. Ratings Services shall establish a firewall policy governing firewalls and operations between Ratings Services and Non-Ratings Business to effectively manage conflicts of interest.</p>	<p>No changes.</p>
II		<p>Rating Services explains the difference to the IOSCO Code in section 6 of their Code of Conduct: “Rating Services operates in multiple global locations, in each case, as a division or a representative of a division of The McGraw-Hill Companies, Inc. or a subsidiary thereof. The McGraw-Hill Companies, Inc. provides shared services to all of its segments, units or divisions, including legal, information technology, human resources and finance functions. In addition, Standard & Poor’s may provide shared services for publishing, modelling, data, sales and communication and marketing functions. In many cases, shared or support services are performed by personnel dedicated to Ratings Services. Ratings Services has implemented a firewall policy to ensure that the rating and surveillance processes are not compromised by conflicts of interest, abuse of confidential information or any other improper influence.”</p> <p>Despite this difference to the IOSCO Code, S&P believes that the agency complies to the Code by explaining the difference and making sure that adequate policies and procedures are in place.</p>	



		<p>S&P says that, at a high level, although Ratings Services is not a separate legal entity within The McGraw-Hill Companies, Inc., it is a effective operational separation in place between Ratings Services and other Standard & Poor's and McGraw-Hill businesses that enables Ratings Services to comply effectively with the spirit of the IOSCO Code in general and provision 2.5 in particular. Ratings Services has implemented a firewall policy to ensure that the rating and surveillance processes are not compromised by conflicts of interest, abuse of confidential information or any other improper influence. Moreover Standard & Poor's has had in place, for many years, firewalls among the business units to safeguard the independence of ratings services. Ratings Services must exercise its editorial and analytic opinions independent from other businesses. In addition, where Ratings Services receives non-public information, it has in place processes to make sure that the information does not become public and that it is not otherwise disseminated. Standard & Poor's relies on the McGraw-Hill Code of Business Ethics and the Ratings Code of Conduct (and its precursors) to formalise the functional and physical separation of business units. For the above reasons and in view of the global scope of McGraw-Hill and Standard & Poor's operations, we have not taken steps to re-configure Ratings Services as a separate legal entity, a decision which entails substantial accounting and tax considerations.</p> <p style="text-align: center;">CESR considers this provision as still not compliant with the IOSCO Code</p>	
2.8	IOSCO CODE	Moody's Code (old)	Moody's Code (new)
I	<p>The CRA should disclose the general nature of its compensation arrangements with rated entities. Where a CRA receives from a rated entity compensation unrelated to its ratings services, such as compensation for consulting services, the CRA should disclose the proportion such non-rating fees constitute against the fees from the entity for ratings services.</p>	<p>Moody's will disclose the general nature of its compensation arrangements with rated entities, including whether it receives compensation unrelated to its Credit Ratings and related research.</p>	<p>MIS will disclose the general nature of its compensation arrangements with rated entities. MIS does not provide Non-Rating Services and as such does not receive from rated Issuers compensation unrelated to its Credit Rating Services or Ancillary Services, such as compensation for consulting services. If MIS were to receive from a rated Issuer compensation for Non-Rating Services unrelated to its Credit Rating Services or Ancillary Services, MIS would disclose the proportion such Non-Rating fees constitute against the fees MIS receives from the Issuer for Credit Rating Services.</p>
II		<p>In the first report, CESR noted that Moody's does not disclose the proportion of fees generated by non rating services. Moody's replied that such fees represent less than 1% of revenues in</p>	<p>Although not indicated in the Code of Conduct, Moody's has specified in a separate policy document entitled "General Nature of MIS' fee arrangements" that ancillary services accounted for less than</p>



		2005.	0.5% of total revenue in 2005 and 2006. CESR considers this provision as compliant with the IOSCO Code
2.12	IOSCO CODE	DBRS Code (old)	DBRS Code (new)
I	The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.	With limited exceptions, DBRS does not have Analysts initiate or participate in discussions regarding fees or payments with any entity they rate. One exception is that Corporate Analysts may quote factual fee-related information to current or proposed Issuers. All other discussions about fees for Corporate ratings are referred to the DBRS Business Development Group. Another exception relates to Structured Finance, where Analysts may discuss fees with clients; however, only DBRS Staff with management responsibilities may act as the decision-maker in fee discussions. Nevertheless, the Structured Finance standard rate sheets outline the fee range for the vast majority of Structured Finance ratings.	DBRS Analysts may quote factual fee-related information and/or send standard fee schedules to current or proposed Issuers, but DBRS Analysts below Managing Director may not negotiate fees with such parties.
II		<p>DBRS edited provision 2.12 of its Code of Conduct. Now, in DBRS's new version of provision 2.12, the agency states that analysts below Managing Director do not participate in negotiating fees with customers. This new version of provision 2.12 is close to the original provision in the IOSCO Code, but allows analysts in the role of Managing Director to negotiate fees.</p> <p>DBRS is a smaller credit rating agency that operates on a global basis such that in some very limited cases, there is an overlap of roles at the Managing Director level. However, DBRS has policies and procedures in place to ensure there are no conflicts when such roles overlap. DBRS believes it appropriately manages this area.</p> <p>CESR considers this provision as still not compliant with the IOSCO Code.</p>	
2.12	IOSCO CODE	Fitch Ratings Code 2006 Report	Fitch Ratings Code 2007 Report
I	The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions	All discussions with issuers and intermediaries concerning rating fees and fee arrangements shall be restricted to members of the global marketing team or to senior personnel in the analytical groups with the title	No changes have been made; the Code of conduct remains that dated April 2005.



	regarding fees or payments with any entity they rate.	of Managing Director or higher. This policy applies to all groups worldwide. Although it is generally not possible to prevent issuers and their representatives from raising issues concerning fees with analysts, in such a case, analysts shall refer the issuer to a member of the global marketing team or their Managing Director.	
II		In their letter to CESR dated May 10, 2007, Fitch Ratings indicate that “business requirements sometimes dictate that certain members of senior management, or certain employees with specialist language skills, must assist in fee discussions while at the same time possibly participating in rating discussions. As we discussed during our meeting last June in Stockholm, such occurrences have fallen in number as we have invested in expanding our business development team, but it is not currently practical or cost effective for Fitch to completely discontinue this practice.” CESR considers this provision as still not compliant with the IOSCO Code.	
2.12	IOSCO CODE	Moody’s Code (old)	Moody’s Code (new)
I	The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate	Moody’s will not have Analysts without Management responsibilities who are directly involved in the rating process for an Issuer initiate, or participate in, discussions regarding fees or payments with such Issuer.	MIS will not have Analysts who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.
II		The new code has removed the condition related to analysts with management responsibilities which allowed for exceptions to be made. CESR considers this provision as compliant with the IOSCO Code.	
2.13	IOSCO CODE	DBRS Code (old)	DBRS Code (new)
I	No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee: (a) owns securities or derivatives of the	DBRS has adopted policies and procedures designed to ensure that the ratings it issues are free from all compromising influences. Among other things, DBRS forbids its staff and Immediate Family to invest in the securities or derivatives of any Issuer that DBRS rates or benchmarks (“Restricted Securities”), other than holdings	DBRS has adopted policies and procedures designed to ensure that the ratings it issues are free from compromising influences. The Company’s restrictions on investments by DBRS Staff in Securities of Issuers are described more fully in Section 2.14 below. In addition to informing the relevant Rating Committee of any



	<p>rated entity, other than holdings in diversified collective investment schemes; (b) owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes; (c) has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; (d) has an immediate relation (i.e. a spouse, partner, parent, child or sibling) who currently works for the rated entity; or (e) has, or had, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.</p>	<p>in diversified collective investment schemes. Restricted Securities that are owned at the time a person becomes a DBRS employee or securities that become Restricted Securities after the employee or his or her family buys them are considered "Grandfathered Securities" which must be reported to the DBRS CCO. Grandfathered Securities can be sold only upon the CCO's prior approval. In order to further ensure the independence and objectivity of the rating process, Analysts must inform the relevant Rating Committee of any of the following situations: (a) the Analyst owns Grandfathered Securities in the Issuer being reviewed; (b) the Analyst had a recent employment or other significant business relationship with the rated Issuer; (c) the Analyst has an immediate relation (spouse, partner, parent, child, or sibling) who currently works for the rated Issuer; (d) the Analyst has a present or past relationship with the rated Issuer or any Issuer related thereto, or with an employee of the rated Issuer. If any of the above situations causes or is perceived to cause a conflict of interest, the Analyst is not permitted to participate as a voting member in the Rating Committee to determine an Issuer's rating.</p>	<p>ownership interest in the Issuer that does not fall within the exceptions listed in Section 2.14, Analysts and Rating Committee members must also inform the relevant Rating Committee of any of the following situations: (a) the Analyst or Rating Committee member owns the Securities of an entity related to the Issuer, other than pursuant to the exceptions noted in Section 2.14 below; (b) the Analyst or Rating Committee member had a recent employment or other significant business relationship with the Issuer; (c) the Analyst or Rating Committee member has an immediate relation (spouse, partner, parent, child, or sibling) who currently works for the Issuer; or (d) the Analyst or Rating Committee member has a present or past relationship with the Issuer or any entity related thereto.</p> <p>If an Analyst or a Rating Committee member has a prohibited ownership interest in the Issuer (as defined in section 2.14) or if any of the other situations described above causes or its perceived to cause a conflict of interest, the Analyst or Rating Committee member will not be permitted to participate in the determination or approval of the subject rating.</p>
<p>II</p>		<p>DBRS revised provision 2.13 and removed the 'grandfathered security' clause. Provision 2.13 in combination with provision 2.14 of DBRS's new Code of Conduct prohibit the ownership of any securities, except the ones allowed by the IOSCO Code. The most important issue of both clauses is that ownership exemptions do not apply for family members accounts, in case DBRS staff reports in writing that the staff member has no direct influence on and no interest in this particular account. Additional information about restrictions on personal securities ownership are given in part II "Additional policies and procedures to prevent the misuse of material non-public information, address conflicts of interest and ensure ethical business practices".</p> <p>CESR considers this provision as compliant to the IOSCO Code.</p>	
<p>3.9</p>	<p>IOSCO CODE</p>	<p>DBRS Code (old)</p>	<p>DBRS Code (new)</p>



<p>I</p>	<p>For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.</p>	<p>DBRS generally is able to obtain the cooperation of an Issuer's management in the ratings process. However, where DBRS is unable to have substantive discussions with an Issuer's management and is not privy to Confidential Information, DBRS may, in its discretion, provide a rating opinion based on public information only. DBRS occasionally issues ratings based on public information only as part of its strategy to provide analysis on all meaningful borrowers in the global markets. DBRS believes that coverage of all major companies in an industry, whether they fully participate in the ratings process or not, benefits the investing public by improving the quality of the ratings report. Peer coverage within an industry also enhances an Analyst's ability to rate other companies, by enabling an understanding of the major differences and subtle nuances among various companies in the industry. Where an Issuer whom DBRS desires to rate declines to cooperate with DBRS, DBRS will notify the issuer of DBRS's intention to initiate coverage, and will make it clear that it is initiating this ratings coverage on a no-fee basis. DBRS Analysts are forbidden to engage in any coercive or punitive conduct with respect to such ratings. All reports and press releases regarding ratings based on public information only, as well as reports and press releases for ratings issued without the full participation of issuers contain the standard DBRS disclosure: "Note: This rating is based on public information."</p>	<p>DBRS generally is able to obtain the cooperation of an Issuer's management in the ratings process. However, where DBRS is unable to have any discussions with an Issuer's management and is not privy to Confidential Information, DBRS may, in its discretion, issue an Unsolicited Rating. DBRS occasionally issues such ratings as part of its strategy to provide analysis on all meaningful borrowers in the global markets. DBRS believes that coverage of all major companies in an industry, whether they participate in the ratings process or not, benefits the investing public by improving the quality of the rating report. Peer coverage within an industry also enhances an Analyst's ability to rate other companies, by enabling an understanding of the major differences and subtle nuances among various companies in the industry. In some cases, DBRS will monitor companies to achieve some of these benefits without publishing publicly available reports.</p> <p>Were an Issuer whom DBRS desires to rate declines to cooperate with DBRS, DBRS will notify the Issuer of its intention to initiate coverage, and will make it clear that it is initiating this ratings coverage on a no-fee basis. DBRS Analysts are forbidden to engage in any coercive or punitive conduct with respect to Unsolicited Ratings.</p> <p>Rating reports and press releases for ratings based on public information contain the standard DBRS disclosure: " Note: This rating is based on public information."</p>
<p>II</p>		<p>DBRS slightly edited provision 3.9 of its Code of Conduct. Now, in DBRS's new version of provision 3.9, the agency speaks of unsolicited ratings instead of ratings based on public information. DBRS still does not state explicitly who initiated the rating but considers that a rating based on public information infers that the issuer is obviously not the initiator of the rating.</p> <p>DBRS considers that its policy on Ratings Based on Public Information</p>	



		<p>(also referred to as Unsolicited Ratings) provides sufficient detail to market participants that it is DBRS who has initiated the rating relationship. However, DBRS would consider revising their policy definition to be more specific in this regard.</p> <p>CESR considers this provision as still not compliant with the IOSCO Code.</p>	
3.9	IOSCO CODE	Fitch Ratings Code (old)	Fitch Ratings Code (new)
I	<p>For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.</p>	<p>Issuers or their agents have requested the substantial majority of Fitch’s ratings. However, in the absence of a rating engagement, Fitch does rate securities and issuers from time to time if Fitch believes there is a substantial market interest in the securities or the issuer or where Fitch believes that its opinion may differ from those prevailing in the marketplace. In any case where Fitch rates securities or an issuer on a Fitch-initiated basis, the fact that the rating is a Fitch-initiated rating shall be disclosed in accordance with Fitch’s established policies and procedures.</p>	<p>No changes made; the Code of Conduct remains the same dated April 2005.</p>
II		<p>Fitch Ratings May 10, 2007 letter to CESR indicates that they believe Fitch do comply with the IOSCO Code; “As a first principle we would note, as CESR itself notes ..., that Fitch does, in fact, disclose both initiation and participation for all published ratings, as well as its policy on this topic. ... Both Fitch’s policy document and details of the initiation and participation status of individual ratings are available on an ongoing basis from Fitch’s free access public website and from its free access public Ratings Desk.”</p> <p>Several attempts to access this information on their site have not succeeded.</p> <p>Fitch Ratings explains that they have experienced technical problems with the element of this disclosure made available via their website. The current system provides a ‘failsafe’ – by allowing users to gain access to this data via the agency’s Ratings Desk, when the initial press release is not available on the website for any reason. The Ratings Desk is free to all – callers do not require a subscription or any registration to receive information by telephone.</p> <p>Fitch Ratings is nonetheless reviewing the web-based provision of this information for potential improvements.</p>	



CESR considers this provision as still not compliant with the IOSCO Code.			
3.9	IOSCO CODE	Moody's Code (old)	Moody's Code (new)
I	For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.	<p>In order to promote transparency, and in accordance with Moody's Policy on Designation of Ratings in Which the Issuer Has Not Participated, Moody's will publicly designate and disclose Non-Participating Credit Ratings.</p> <p>Moody's has not assigned Unsolicited Credit Ratings in the recent past. However, as a publisher of opinions about credit, Moody's reserves the right in the future to issue Unsolicited Credit Ratings if Moody's believes: (i) there is a meaningful credit market or investor interest served by the publication of such a rating; and (ii) it has sufficient information to support adequate analysis and, if applicable, ongoing surveillance. When a Credit Rating is an Unsolicited Credit Rating, Moody's will not seek or accept remuneration for its analytical services from the Issuer for at least one year after the publication of such rating.</p>	<p>In order to promote transparency, and in accordance with MIS's Policy on Designation of Ratings in Which the Issuer Has Not Participated, MIS will publicly designate and disclose Non Participating Credit Ratings.</p> <p>MIS has not assigned Unsolicited Credit Ratings in the recent past. However, as a publisher of opinions about credit, MIS reserves the right in the future to issue Unsolicited Credit Ratings if MIS believes: (i) there is a meaningful credit market or investor interest served by the publication of such a rating; and (ii) it has sufficient information to support adequate analysis and, if applicable, ongoing surveillance. In accordance with MIS's Policy on Designating Unsolicited Credit Ratings, when a Credit Rating is an Unsolicited Credit Rating, MIS will not seek or accept remuneration for its analytical services from the Issuer for at least one year after the publication of such rating.</p>
II		<p>A number of minor changes have been made to the wording; however, the meaning remains essentially the same as the prior version. Furthermore, in the Policy document entitled "Designating Unsolicited Credit Ratings" dated April 2006, Moody's indicates that it will designate an unsolicited credit rating "in the initial Credit Rating announcement". This means that any subsequent announcement will not necessarily carry that designation. In their April 11, 2008 letter to CESR, MIS indicates that it believes "that the 'Unsolicited Rating' designation seeks to identify who initiated the relationship between the issuer and the rating agency. In our view, a relationship can either be initiated at the request of an issuer, thereby rendering it a solicited relationship, or at the initiative of the rating agency, thereby rendering it an "unsolicited" relationship. Accordingly, we believe that the appropriate time to disclose the "unsolicited" nature of such a rating relationship is at the initial stage. Going forward, if an issuer chooses not to participate in the rating process, an Unsolicited Rating at the time of issuance would become a Non-Participating Credit Rating and would be disclosed as such in our list of Non Participating Ratings that is maintained on our website." CESR believes that the change of name from "unsolicited" to "non-participating" does not maintain the</p>	



		<p>connotation that the issuer has not requested the rating whether the initial or a subsequent one and in fact could perhaps be considered as misleading.</p> <p>CESR considers this provision as still not compliant with the IOSCO Code.</p>	
3.9	IOSCO CODE	S&P Code (old)	S&P Code (new)
I	<p>For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.</p>	<p>Unsolicited ratings are ratings assigned by Ratings Services without the full participation of issuers in the rating process. Ratings Services reserves the right, in its sole discretion, to issue ratings without the full participation of issuers in the rating process if Ratings Services believes (i) there is a meaningful credit market or investor interest served by the publication of such a rating, and (ii) it has sufficient information to support adequate analysis and, if applicable, ongoing surveillance. Ratings Services shall indicate if a rating is an unsolicited rating. In some cases, issuers may provide limited information to Ratings Services and Ratings Services would still consider those ratings to be unsolicited ratings. Ratings Services shall disclose its policies and procedures regarding unsolicited ratings without charge to the public on Standard & Poor's public website www.standardandpoors.com.</p>	<p>No changes.</p>
II		<p>Rating Services explains the difference to the IOSCO Code in section 6 of their Code of Conduct: "Ratings Services believes that ratings must be credible and must be based on information available from all sources, including information received from issuers that may affect unsolicited ratings. Ratings Services issues unsolicited ratings only when it believes that it has sufficient information to be able to reach a robust credit opinion. Ratings Services uses the following disclaimer for all of its unsolicited ratings: "This rating(s) was initiated by Standard & Poor's Ratings Services and may be based solely on publicly available information and/or may not involve the participation of the issuer's management." Ratings Services does not believe that it is necessary to differentiate between unsolicited ratings that were issued without any participation by the issuer and an unsolicited rating that involved issuer participation. The disclaimer identifies unsolicited ratings without adding a level of complexity that may be misleading to investors.</p> <p>Despite this difference to the IOSCO Code, S&P believes that the</p>	



		<p>agency complies with the Code by explaining the difference and making sure that adequate policies and procedures are in place.</p> <p>CESR considers this provision as still not compliant with the IOSCO Code.</p>
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211. The table above shows that there are still some areas where the CRAs do not comply with the IOSCO Code, and where CESR sees room for improvement. Since the present framework relies on a comply or explain approach, CESR does not mean to say that the CRAs are necessarily in breach of the Code. The purpose is rather to point out where CRAs do not comply directly with the letter of the Code. This non-compliance, even though there are explanations, indicates that some of the issues which the IOSCO Code is intended to address, are not being managed through the CRAs Codes in a manner that matches the IOSCO Code provisions exactly. In some cases CESR has decided that one or more CRAs are non-compliant as they do not feel the explanation given meets the goals of the provision (for example the inclusion of rating impact assessment services as core ratings business).

212. The following section contains CESR's additional remarks to the Code of Conduct of each individual CRA:

DBRS

213. DBRS new Code of Conduct adequately addresses several issues mentioned in CESR's last report to the European Commission (published in 2007, available through www.cesr-eu.org). The new and extended Code of Conduct consists of two parts: The Code of Conduct and a paper on "Additional policies and procedures to prevent the misuse of material non-public information, address conflicts of interest and ensure ethical business practices".

214. DBRS basically edited most of the provisions of the Code of Conduct to clarify the wording and change misleading expressions. Furthermore, many minor differences identified by CESR's report were removed by DBRS.

215. Part two contains previously independent documents which were highly linked with DBRS Code of Conduct, but not as easy available as the Code of Conduct itself. This second part explains in detail several provisions and gives additional information.

216. It seems that DBRS has indeed tried to improve the implementation of the IOSCO Code by translating additional provisions into their own policies and procedures published in their Code of Conduct.

Fitch Ratings

217. The Code of Conduct that is published on Fitch's website as of the first quarter 2008 is that dated April 2005. The CESR Report of 2006 indicated that the Fitch Code was not fully compliant with the IOSCO Code in three domains. Fitch's letter to CESR dated May 10, 2007 indicates, however, that they believe that their Code is in compliance with the IOSCO with the exception of one point regarding the participation of analysts in fee discussion which they maintain is needed in certain circumstances. There is no indication on their part of the intention to make any changes to their Code in order to render it compliant with the Code.

Moody's Investors Services

218. Moody's published in October 2007 a revised Code of Conduct which demonstrates some improvements. It now provides for the separation of credit rating analysts both operationally and legally from the remaining services.



219. Although not contained in their Code of Conduct, but rather in a policy statement, Moody's has indicated that the percentage of total revenue from non rating services is negligible.
220. The new code has removed the condition related to analysts with management responsibilities which allowed for exceptions to be made in provision 2.12. CESR considers now this provision as compliant with the IOSCO Code. However, CESR would like to highlight that the word Moody's Code uses is "analysts" in contrast to "employees" in the IOSCO Code wording and it could be possible that CRA employees other than analysts could participate in the rating process.
221. CESR understands that, as the vast majority, if not all, of the rating process will be conducted by analysts, the fact that the Code does not replicate the exact wording of the IOSCO Code provision should not be an issue in practice. However, CESR will monitor this issue and will revisit its conclusion if the spirit of the provision is not met.
222. The provision in Moody's Code concerning the designation of unsolicited ratings remains essentially the same.

Standard & Poors

223. Rating Services' new Code of Conduct adequately addresses one of the issues mentioned in CESR's last report to the European Commission. The new Code of Conduct differs in a new wording of provision 1.15. All other provisions did not change at all. S&P rather explain why they believe that the other two provisions mentioned in CESR's report do not need any change. Section 6 of Rating Services Code of Conduct states that *"there are two areas in which the provisions of the Code differ from the provisions of the IOSCO Code: (i) Ratings Services operation and legal separation and (ii) the rating process for an unsolicited rating. Notwithstanding these differences, Ratings Services believes that the independence, integrity, credibility and objectivity of the rating and surveillance processes is not affected and, therefore, the IOSCO Code's essential purpose will be achieved."*
224. CESR would like to highlight that the wording included in the S&P Code for provision 2.12 also refers to "analysts" in contrast to "employees" in the IOSCO Code wording and it could be possible that CRA employees other than analysts could participate in the rating process. However, as said above for Moodys, CESR understands that, as the vast majority, if not all, of the rating process will be conducted by analysts, the fact that the Code does not replicate the exact wording of the IOSCO Code provision should not be an issue in practice. However, CESR will monitor this issue and will revisit its conclusion if it finds out that the spirit of the provision is not met.

General conclusions on the analysis of the changes to the CRAs codes of conduct

225. As already mentioned in CESR's first report, 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.



V. CONCLUSIVE CONSIDERATIONS BY CESR

4.A. Work in progress: changes underway

226. As a consequence of the current market turmoil, regulatory organisations and industry have taken several initiatives to meet the concerns raised by investors and other market participants.
227. For example, IOSCO is consulting, until 25 April, on its proposals to include several new provisions in the IOSCO Code to deal with the shortcomings in the rating of structured finance transactions.
228. In addition, several CRAs have worked together to respond in a concerted manner to the market and regulatory concerns (see section I F on CRAs initiatives). The CRAs are currently interacting with regulators and market participants to discuss those and other additional potential measures aimed at promoting market confidence.
229. The initiatives above together with other work in progress may result in changes that may address concerns discussed in the report and should therefore be important factors to consider when advising the EU Commission. Planned and suggested improvements identified by CESR are summarized in the table below.

	CESR's views	New proposed provisions in the Code of Conduct Fundamentals²¹	CRAs joint initiatives on specific measures for discussion²²
Transparency	<p>CRAs need to make greater on-going efforts to clarify the central characteristics and limitations of their rating of structured finance products.</p> <p>CRAs need to improve the accessibility of the information they provide.</p> <p>CESR stresses the need for CRAs to provide information on critical</p>	<p>CRAs should assist investors in understanding what credit rating is, the attributes and limitations of each credit opinion. (provision 3.5)</p> <p>IOSCO wants the CRAs to provide investors/subscribers with the information to understand the basis for the CRA's rating, including sufficient information about the code of conduct, methodologies and historic performance data (provision 3.5 and 4.3).</p> <p>If the rating involves a type of financial product presenting limited historical data the CRA</p>	<p>CRAs should clearly indicate attributes and limitations of credit ratings opinions. They should also play an active role in raising awareness among investors and other market participants about the meaning and intended purpose of rating process and the CRA's role in the financial market.</p> <p>Providing more disclosure about key model and methodology</p>

²¹ Consultations report - The role of credit rating agencies in structured finance markets, March 2008.

²² Discussion Paper about Measures to Enhance the Independence, Quality, and Transparency of Credit Ratings.



	<p>model assumptions, in particular, the weightings of key parameters and correlations underlying structured finance ratings.</p> <p>CRA's should highlight clearly to investors which particular methodology a rating for a structured finance product is based on.</p> <p>The market would benefit if a greater level of public and standardized information could be generated.</p>	<p>should make clear the limitations of the rating and any risks associated with credit rating of such products (provision 1.7).</p> <p>Each rating should indicate the principal methodology or methodology version that was used in determining the rating (provision 3.3).</p>	<p>assumptions and stress-testing of assumptions.²³</p> <p>CRA's should help to establish a centralized repository for ratings performance studies to allow easier market comparisons among the CRA's.</p>
Human resources	<p>CESR to improve disclosure of selective human resources indicators that would contribute to increase market confidence that CRA's are adequately resourced to provide accurate and high quality ratings.</p>	<p>(Refer to new provisions in relation to monitoring below).</p>	
Monitoring	<p>CRA's must dedicate sufficient resource to their monitoring functions and maintain the operational flexibility to allow them to dedicate resource to reviewing outstanding ratings where necessary, to ensure punctual action is taken.</p>	<p>CRA's should ensure that adequate personnel and financial resources are allocated to monitoring and updating their ratings (provision 1.9).</p> <p>Where CRA's use separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, each team should have the requisite level of expertise and resources to perform</p>	<p>CRA's should establish separate teams for initial credit ratings and ongoing surveillance of structured finance transactions, whenever feasible.</p>

²³ Credit Rating Agencies' Statement and Progress on initiatives to Strengthen CRA Performance and Enhance Confidence in the Credit Rating Process.



	<p>CRAs should ensure that their rating methodologies are reviewed sufficiently often.</p>	<p>their respective functions in a timely manner (provision 1.9.1).</p> <p>CRAs should establish an independent function responsible for periodically reviewing the methodologies and models and changes to the methodologies and models it uses (provision 1.7-2).</p>	<p>CRAs should conduct formal, periodic, internal reviews of rating criteria and methodologies to promote ratings quality.</p>
<p>Conflicts of interests</p>	<p>CRAs should ensure they are fully transparent with regard to the exact nature of their interaction with issuers/arrangers of structured finance products. CRAs should 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.</p> <p>A clearer consensus over what constitutes advisory activity in the structured finance rating process would be beneficial to the market.</p> <p>There needs to be greater clarity over what constitutes ancillary business and what constitutes core rating services</p> <p>CRAs should provide greater disclosure of all aspects of structured finance fees, included around 'failed', or 'non-issued' ratings.</p>	<p>CRAs should prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates (provision 1.14-1).</p> <p>CRAs should define what it considers and does not consider to be an ancillary business and why (provision 2.5).</p> <p>CRAs should disclose 'failed', or 'non-issued' ratings (provision 2.8).</p>	<p>CRAs should explicitly forbid credit rating analysts from making proposals or recommendations regarding the creation or design of securitization products.</p> <p>CRAs should not provide consulting or advisory services.</p>



B. Policy Options

Summary of responses on the questions relating to policy options of CESR's Consultation Paper

230. CESR sought views on the costs and benefits of the current self regulatory regime it had set out in the consultation paper. Overall, market participants were very much in accordance with CESR's assessment of the benefits and costs of the current self-regulatory framework.
231. The most important advantages highlighted in the responses are its high degree of flexibility, its cost effectiveness and the international approach as the IOSCO Code provides for globally recognised minimum standards.
232. Regarding the benefits, one respondent additionally pointed out that one of the key advantages of the current regime is that it removes from the regulator the burden of the responsibility.
233. The most relevant shortcoming of the current system identified by market participants is that there is no arbitration or enforcement mechanism to guarantee compliance with the IOSCO provisions. This problem is aggravated by the oligopolistic structure of the industry, which means that issuers are not often in a position to switch to other providers of ratings.
234. CESR also asked whether it had correctly identified the likely benefits and costs related to formal regulatory action. In general, market participants, here too, agreed with CESR's assessment. However it was pointed out that the exact benefits and costs of formal regulatory action would very much depend on the exact regulatory design and also on the consistency of the European regulation with international developments.
235. Respondents considered that the most important advantage of a formal regulatory framework would be the possibility of strict enforcement of CRAs compliance with the minimum standards.
236. Regarding the risks of regulation, many market participants stressed that formal regulation lacks flexibility to adapt to changing circumstances and it lacks immediate access to industry knowledge from practitioners. Also, the possibility of inconsistency between regulations across major financial markets was seen as a major risk.
237. In addition to the costs of regulation identified by CESR, some market participants also pointed out that incremental requirements would have an adverse impact on competition.
238. Finally, CESR asked whether the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation.
239. All respondents agreed that a key measure to improve the current regime would be the amendment of the IOSCO Code.
240. Some market participants argued that those changes to the IOSCO Code plus enhanced transparency from the CRAs are sufficient to address the perceived weaknesses in the market. Therefore the current self regulatory regime should be maintained possibly making the current informal CESR monitoring more effective or putting in place a monitoring function at IOSCO level.
241. The high level of attention paid by CESR and other regulators and supervisors worldwide was cited as a very powerful incentive for the CRAs to comply with the voluntary provisions of the IOSCO Code. However, some market participants considered that the threat of regulation has not been enough to fix the imperfections of the ratings market.
242. These respondents considered that the proposed modifications of the IOSCO Code that would address the concerns raised by CESR are not sufficient and asked for adjustments in the regulatory framework.



243. Those market participants not satisfied with the current self regulatory regime argued that the creation of an industry body representing CRAs, that can make binding commitments for its members, could play an important role in strengthening self regulation. On the contrary, another respondent thinks that in light of the oligopolistic features of the market, the creation of an industry body to interface with regulators would not add much value. Regarding the recent CRAs initiatives, one financial market institute points out that the current organisation of CRAs is little more than an “ad hoc” voluntary association brought into existence by the current disruption in the credit markets.
244. In general, those advocating for adjustments to the current system didn’t think an industry body would be sufficient. Some respondents considered that a more rigorous self-regulatory regime is needed.
245. This could be brought about by a special committee or body consisting of representatives from supervisory authorities, CRAs and market participants, with the task of monitoring compliance with the IOSCO Code –including if necessary sanctioning transgressions- and possibly arbitrate cases of disagreements between market participants or supervisors and CRAs over the interpretation of the IOSCO Code. In order to achieve consistency across all major markets its composition should be agreed with the SEC and supervisors in other countries. Some respondents thought this role could be played by IOSCO.
246. One respondent from the banking industry considers that a possible regime could provide for an external public or semi public auditor entrusted with the task of monitoring the CRAs activities (basically to monitor that conflicts of interests are duly managed).
247. A more formal regulatory framework might also be an option and should not be dismissed easily as long as the success of an extended self regulatory approach is not evident.
248. Some market participants suggested that at this stage there is already a comprehensive argument in favour of regulation of CRAs to address the shortcomings identified by CESR in the consultation paper. They think that whilst product regulation should not be implemented, as it would not be flexible enough, a regulation governing the conduct of business of the CRAs – conflicts of interests and transparency- is necessary.
249. Other alternative solutions have been put forward. One respondent considers that the role of CRAs is clearly important but it is given too much focus. Attention should be paid towards complementary measures, which help to evolve a more comprehensive overall framework of independent risk analysis and transparent opinions in structured finance. This should include a more level playing field in terms of access to relevant information and ensuring investors are involved much earlier in the iterative analysis process – thereby disintermediating the role of bank arranger teams to some extent. It proposes that regulators act as a consolidator of data, either by creating a national or EU level repository or by ensuring that all issuers and various third party data providers make performance data publicly. Also the response makes a set of concrete suggestions to facilitate the availability of dissenting opinions (by other CRAs or other market participants).
250. Finally, some respondents asked regulators to take a critical look at how they use ratings issued by CRAs and explore alternative yardsticks (i.e. ECAI recognition).

Policy option

251. In the previous sections (section III C) of this paper CESR has set out, after consulting with market participants, its views on the issues requested by the Commission.
252. As discussed in the previous section V.A there are several initiatives underway that, if implemented effectively, could address most of CESR’s concerns. In particular, market participants unanimously consider that IOSCO’s proposals for the modification of its Code are a key measure to improve the current regime. The IOSCO Code has, since its publication in



December 2004, become a reference in the rating industry and has become the benchmark for CRAs to follow. The IOSCO Code, including the proposed modifications, should be regarded as the minimum upon which to build the enhanced framework suggested in the following paragraphs.

253. CESR very much welcomes these initiatives and believes they are important steps in the right direction. However, given the influential role that CRAs play in the structured finance sector, CESR considers that the proposed measures are still not sufficient in a number of areas as outlined in section III C.
254. CESR considers there is a clear need for specific measures to address one of the critical concerns in the structured finance rating business: whether the current process for rating structured finance securities involves advice that necessarily presents a conflict of interest. CESR does not think that the suggested new provision 1.14-1 provides sufficient clarity as to what constitutes advice in the structured finance business. CESR considers that the IOSCO Code should be clearer on this issue.
255. Also CESR does not believe that the approach taken by IOSCO to amend provision 2.5 of the IOSCO Code to request CRAs to define what they consider and do not consider to be ancillary business and why, is enough. CESR feels that consensus about what constitutes ancillary services in this sector is critical to ensure the integrity of the process. In this regard, CESR considers that immediate action by IOSCO is necessary and the common definition should be included in the IOSCO Code. CESR has informed IOSCO about this concern.
256. In addition, it is still early to judge whether IOSCO and CRAs' initiatives in other areas of concern to CESR will effect sufficient change in the way CRAs operate to restore investors' confidence in the rating industry.
257. However, the above does not necessarily mean that a full regulatory regime is required. CESR and market participants still believe that there is no evidence that regulation would have had an effect on the issues which emerged with ratings of US subprime backed securities.
258. Some commentators have argued that there is already some sort of regulation in the EU. The Capital Requirements Directive (CRD) allows institutions to use ratings to determine the risk weight of their exposures, provided that the CRA that produces those ratings has been recognised as eligible for that purpose by the competent authority. However, the recognition of a CRA as eligible External Credit Assessment Institution (ECAI) should not be taken as indicating suitability for any purpose other than the calculation of regulatory capital requirements using the Standardised Approach or the Securitisation Ratings Based Approach set out in the CRD. In addition, it is also relevant to bear in mind that the focus of the CRD recognition criteria is mainly on market acceptance and that the responsibility of their assessment is not made at an EU level but on a national basis by each competent authority. Therefore, this regime cannot be considered as a regulation governing the conduct of business of CRAs, which is the issue under discussion in this report.
259. Additionally, CESR recognizes that the use of ratings in the regulatory and supervisory framework could induce uncritical reliance on credit ratings as a substitute for independent evaluation. In this respect, some respondents asked regulators to take a critical look at how they use ratings issued by the CRAs, for example in the CRD.
260. Despite the statement in paragraph 257, the events of last year surely merit a thorough re-evaluation of the current self-regulatory regime. The public debate has made evident that CRAs perform an important role and are a key element in the structured finance market as it is currently organised. Therefore, although CRAs' ratings are legally no more than opinions, there is a clear public interest aspect to the information the CRAs provide. This leads CESR to believe that there is a strong need to take a step forward in ensuring integrity and confidence in the rating industry and encouraging the effective use of ratings by investors.
261. In particular, as highlighted by respondents to CESR's consultation paper, one of the weaknesses of the current regime in the rating sector is that there are no clear market sanctions in



case of transgressions of the IOSCO Code. It has often been argued that the most powerful incentive for the CRAs to ensure the quality and integrity of their ratings is the potential reputational risk. However, many respondents claim that market forces alone cannot remedy all the shortcomings of the current system. The oligopolistic market structure certainly means that market participants are often not in a position to switch to other rating providers.

262. The rating industry has not acted of its own volition to address this concern as CRAs have not, for example, developed any organised way (such as an association or body) that would monitor compliance with the IOSCO Code provisions and/or that could develop industry standards.
263. Other industries in the financial sector which also have a public interest aspect (i.e. auditing and accounting) have created such bodies in the past with the objective of setting standards and monitoring members' compliance with them. The global dimension of the accounting and auditing standards have called for global solutions in the oversight of the industry. Thus, the bodies created to perform this function have an international nature.
264. These market solutions have contributed to the enhancement of the quality and integrity of the services provided by the industry players. However, in the past years there has been a need to improve the system through the establishment of oversight bodies whose members are appointed by the regulatory community.
265. A recent example in the auditing sector is the establishment in February 2005 of a Public Interest Oversight Board (PIOB)²⁴. The PIOB has the objective of increasing the confidence of investors that the public interest activities of the International Federation of Accountants (IFAC) are properly responsive to the public interest. The IFAC appoints the members of the International Auditing and Assurance Standards Board (IAASB).
266. The PIOB is comprised of eight members coming from a number of professions and all branches of regulation. The members are nominated by IOSCO, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, and the World Bank. In addition, the European Commission nominates two observers to the PIOB.
267. Another initiative along these lines in the accounting area is the combined statement of the European Commission, the Financial Services Agency of Japan, IOSCO and the SEC (7 November 2007)²⁵ proposing the establishment of a new monitoring body within the governance structure of the IASC Foundation to reinforce the existing public interest oversight function of the IASC Foundation Trustees. The key objectives of this monitoring body would be to discuss, review and comment on the IASB's work program, to participate in the selection of Trustees, to review the Trustees' procedures for overseeing the standard-setting process and to ensure the IASB's proper funding.
268. CESR considers that there are good arguments for looking at these initiatives of creating oversight bodies in the auditing and accounting sectors when considering the steps to take to improve the rating industry functioning. As in the areas mentioned, there is a public interest aspect and the relevance of the international dimension is also clearly present in the rating industry, especially since three of the largest CRAs have their legal domicile outside the EU.
- 269. Therefore, CESR recommends the European Commission to form, as an immediate step, a CRAs standard setting and monitoring body of the following nature:**

- **The objectives of the body should be:**
 - i. **to develop international standards for the rating industry in line with the steps taken by IOSCO; and**

²⁴ For more detailed information refer to PIOB's website (www.ipiob.org)

²⁵ The full text of the statement is available under: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/451&type=HTML&aged=0&language=EN&guiLanguage=en>



ii. 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 and investment firms to ensure that the views of all participants in the rating process are adequately reflected;
 - senior representatives of CRAs should also be part of the body when acting in its standard setting capacity but not when performing its monitoring activity;
 - from different geographic areas to ensure the international nature of the body;
 - appointed in its majority by the international regulatory community (for example, the 3 Level 3 Committees –CESR, CEBS, CEIOPS-, IOSCO, etc.) to ensure their independence; and
 - accountable to those who appointed them.

CESR takes for granted that CRAs will provide sufficient information so that the body would be able to meet its objective of adequately monitoring the compliance of CRAs to the standards. CESR also assumes that the Commission will take the necessary steps to ensure that this body can fulfil its mandate.

270. CESR considers that, for this body to fulfil its purpose, it should have the support of the market. Therefore the Commission should ensure that all types of relevant stakeholders are represented in this body. The individuals appointed must have the necessary authority in the market and contribute actively to the work of the body.

271. As mentioned before, it would be desirable that supervisory authorities from other major financial centres besides the EU support the creation of such a body. However, if this international involvement can not be achieved, CESR would still recommend the formation of such a body at EU level.

272. In the absence of support from market participants or failure of the body to meet the objectives of ensuring the integrity and transparency of ratings, CESR considers that this initiative would not add value and that the supervisory authorities should step in to ensure, probably through regulation, the integrity and quality of the rating process. Before taking such a decision, CESR would expect the Commission to conduct an impact assessment of any potential measures according to its usual internal procedures.

273. The proposal outlined above would keep the flexibility of self regulation but at the same time would bring more discipline to the industry, as one of their main functions would be to monitor and report on the compliance with the international standards. Besides it would create a forum for exchanging views between all participants in the rating process and would increase the understanding of ratings. Thus, improving the integrity of the rating process and enhancing investors' confidence.

274. The funding of the activities of this oversight body should be such that would not interfere with its independent nature. The debates that are currently taking place in other financial industries (i.e. IASB)²⁶ would be of great use when proposing an adequate funding system for this body.

275. In order for this to be an international solution, CESR urges the Commission to take immediate action to contact relevant authorities such as US regulatory authorities with the aim of collaborating in the setting up of a single group of international nature. It would be crucial to ensure the international dimension of such a standard setting and monitoring body, and it would surely be useful for the European Union to benefit from any possible initiative at international level that might take place in the short term.

276. CESR wishes to emphasize that its proposal outlined above (either with an international dimension or with a European one) should be implemented within a short time period. To that end, CESR would encourage the European Commission to prepare a calendar setting deadlines for

²⁶ <http://www.iasb.org/News/Press+Releases/Update+on+Funding+for+2008.htm>



the different steps to be followed. Unjustifiable lack of progress according to the timetable should lead the Commission to shift to the consideration of supervisory oversight structures (as envisaged in paragraph 272). Also, once the “CRAs standard setting and monitoring body” has been created, CESR considers that the Commission should put in place a mechanism to periodically assess whether the body is fulfilling its objectives.

277. CESR acknowledges the complexity of forming such a body in a short period of time and is willing to collaborate with the European Commission on the development of the project. Should the European Commission consider it appropriate, and if necessary in the start up phase, CESR could study the possibility of providing some secretariat-type support.



ANNEXES TO THE REPORT



Annex A: European Commission request to CESR for annual report on CRAS compliance with IOSCO Code



EUROPEAN COMMISSION

Internal Market and Services DG
Director general

CESR
ARRIVE
ON: 07/05/07
N°: 07-281

Brussels, 26.04.07 1653
Markt G3 FF/D (2007)

Mr Eddy Wymeersch
Chairman
CESR
11-13 Avenue de Friedland
75008 Paris - France

Subject: Annual report on Credit Rating Agencies

Dear Mr Wymeersch,

CESR's first monitoring report to the European Commission on the compliance of credit rating agencies (CRAs) with the IOSCO Code of December 2006 provided a very useful basis for the Commission to evaluate CRAs' compliance with the IOSCO Code. The survey on the day-to-day application of the IOSCO Code, in addition to the review of the codes of conduct of the respective CRAs, was particularly appreciated.

For now, the Commission believes that the case for new legislation remains unproven. However, considering the report's main conclusions, the Commission thinks that CRAs should continue their efforts to comply with all the Code's provisions and the Commission will be pushing for improvements in these areas of CRAs' activities where shortcomings, in particular the management of conflicts of interest in relation to CRAs' ancillary services and the transparency regarding unsolicited ratings, have been identified. Moreover, the Commission will continue to monitor the global development of the rating business.

As part of the Commission's approach, I would like to ask CESR to prepare a second report on CRAs' compliance with the IOSCO Code by the end of this year. First of all, the report should highlight the changes in the internal codes of conduct of CRAs vis-à-vis the IOSCO Code and the developments regarding the deviations identified in the 2006 report. It would also be useful if CESR could address specifically in its report the rating process as regards structured finance instruments (e.g. quality of rating process, conflicts of interest). An analysis of the CRAs' actual responses to prevailing market developments (like the current concerns associated with the sub-prime mortgage market) may be helpful in this context. An assessment of the level of day-to-day application of the IOSCO Code provisions by the CRAs on the basis of a survey of all stakeholders would be another important element of the second report of CESR.

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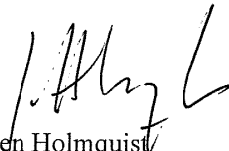
Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.

http://ec.europa.eu/internal_market/



Finally, it would be appreciated if CESR could provide its views on the impact of global regulatory developments, in particular the new US legislation and implementing rules, on the rating business in the EU.

Yours sincerely,



Jörgen Holmquist

Contact:

Felix Flinterman, Telephone:(32-2) 299 69 57, Felix.Flinterman@ec.europa.eu

CESR



European Commission Issues an Additional Request to Review the Role of Credit Rating Agencies
Annex B: European Commission Additional Request to Review the Role of CRAs in Structured Finance



CHARLIE McCREEVY
MEMBER OF THE EUROPEAN COMMISSION

B-1049 BRUSSELS

11.09.2007 D/001752

Mr Eddy Wymeersch,
Chairman CESR
11-13 Avenue de Friedland
F - 75008 Paris

Subject: Additional request to review role of credit rating agencies (CRAs)

Dear Eddy,

Considering the turmoil in the US sub-prime mortgage market, I would, as a matter of urgency, appreciate if CESR could specifically address the following points in its review of the rating process as regards structured finance instruments.

First of all, the interaction between rating analysts and arrangers of structured finance products: Critics stipulate that in playing an iterative guidance role – albeit an informal and unremunerated one - in their interactions with arrangers and investment banks on the design of the structured finance product, the independence of rating agencies and, consequently, the integrity of the rating and the process may be compromised, with the risk of rating agencies being pressured to compete with one another on the grading of particular structures.

As previously discussed, the business model of various CRAs - where issuers pay for the rating - constitutes a long recognised potential conflict of interest which might affect the independence of the rating process. It would be very helpful if CESR could carefully assess the extent to which CRAs follow the existing (IOSCO) Code and indicate whether – in the light of the substantial growth in rating of securitizations in recent years - this Code adequately and effectively addresses the potential conflicts of interest issue particularly in respect of securitization and structured credit. The conflict risks could have the potential to be more pronounced for securitization and structured credit than for the rating of conventional corporates. It would be helpful to focus on this latter issue because of the potential for a bigger stream of future earnings for a rating agency from an originator/issuer of securitized assets/structured finance than would be possible or likely from a more conventional corporate issuer. There is also the potential for rating agencies to compete in respect of the structures required for a given rating mix for individual securitization/structured finance issues.

The transparency of CRAs' rating methodologies and in particular the ability and ease with which investors have been able to track changes to those methodologies and to the series of changes to the assumptions used in their rating models are also issues of concern which I would like CESR to address. CRAs appear to have provided limited information about the key differences between the reliability of corporate and structured finance ratings. Therefore, it would be useful to understand how the transparency of the CRAs' rating process and their rating methodologies can be improved, and to have your views on whether the CRAs provided investors with adequate warnings about the limitations of the assumptions that were input into the rating models – such limitations being due possibly to the absence of sufficient historical data and experience on securities issues and structures of this kind over a number of credit cycles.

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Doubts have also been raised about whether CRAs have adequate resources to understand the rapidly changing and growing complex structured finance market. For example, it has been argued that the high turnover of analysts within CRAs affects the quality of the rating decisions. In this regard it would be helpful to plot the growth in the amount and experience profile of professional human resources allocated by the rating agencies to rating securitized assets over the past ten years against the growth in the number of securitization issues rated by them over that time. In addition, trends in the pace of staff turnover at both credit committee level and analyst and trainee analyst levels below that level would be informative.

Furthermore, the apparently slow response of CRAs to the problems in the sub-prime mortgage business has raised concerns about the timeliness of rating decisions in the field of structured finance, especially as there has been ample evidence of a deterioration in this market since at least the second half of 2006, culminating in sizeable provisioning by leading market players in the first quarter of the current year. CESR's views on the quality of ratings and the timing of rating decisions - including the timing of decisions to put ratings on "watch"- would therefore also be very welcome. I would appreciate your views too as to whether regular (quarterly or half-yearly), formal and published reviews of all individual structured finance ratings might be necessary, even mandatory.

I believe that a thorough analysis is also warranted of the pace of grade migration in different classes of securities, including in particular the pattern and pace of migration in the years running up to a default. This is necessary in order to come to a view on the relevance of the "macro" default statistics provided by the rating agencies. Your views on the appropriateness of a volatility indicator being attached to the structured product ratings would also be helpful.

It would be helpful to get the views of CEBS on the role of CRAs within the context of the Basel II framework to see if there are further concerns.

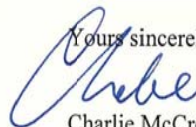
Finally, as rating agencies make the argument that avoiding the risks of conflicts of interest is important from the perspective of protecting their long term franchise, an examination of their remuneration structures and those of their management hierarchy in their parent companies would be appropriate in order to establish whether the performance-linked aspects of the remuneration structure are sufficiently deferred to ensure that, having regard to the length of many credit cycles, there is indeed sufficient incentive for the long term value of the rating franchise to be at the forefront of their priorities when managing the business.

I would like to receive CESR's preliminary views and policy advice on these issues as soon as possible but in any event not later than April 2008 when CESR is due to present its already planned annual report of the role of CRAs' and their compliance with the IOSCO Code .

I would suggest CESR also consults the SEC on these questions which are, at the same time, subject to examination by the Commission services. I would appreciate if you would keep them and my cabinet informed about the progress of your review and the work methodologies you are pursuing.

In conclusion, let me say that I attach the utmost importance to this task and see it as a priority issue.

I am most grateful for your help.

Yours sincerely,

Charlie McCreevy