

Role of Credit Rating Agencies

ESME's report to the European Commission

June 2008

Contents

1. Introduction, background and answers to the general questions
2. Responses to the European Commission's specific questions
- 3. ESME's conclusions and recommendations**
4. Appendix I: US regulation of CRAs
5. Appendix II: ESME's Mandate
6. Appendix III: ESME membership
7. Bibliography

Responses to the Commission's questions

Introduction

This report is the result of ESME's work on Credit Rating Agencies ("CRAs") mandated by the European Commission ("EU Commission") in November 2007. Since then, members of ESME, in addition to their own knowledge and experience with CRAs, reviewed a large number of independent research papers, publications, articles and reports on CRAs, as well as following closely the various international initiatives, e.g. International Organisation of Securities Commissions (IOSCO), Institute of International Finance (IIF), Bank for International Settlement (BIS). In addition, ESME held meetings and discussions with a number of stakeholders including two offsite meetings with senior management of each of the three largest CRAs in London (Fitch Ratings, Moody's Investor Service, Standard and Poor's) as well as Fair Isaac, a range of users of ratings and investment research firms.¹ Based on this research ESME formulated and articulated its own independent view as a group of market experts, which forms this report.

In order to answer the EU Commission's questions in a clear and consistent way while simultaneously putting forward specific conclusions and recommendations, the following structure has been adopted:

- The **first part** of the report responds to the general questions which address the role of CRAs in the financial markets and the current regulation of CRAs. For the purpose of answering these general questions in a comprehensive way, ESME has also provided its views on a wider range of issues, e.g. CRAs' business model, meanings of ratings, corporate vs. structured finance ratings and the genesis of the turmoil in the credit markets.
- The **second part** specifically addresses the precise questions set out in the mandate.
- The **third part** defines a number of key issues around CRAs and provides the EU Commission with a set of recommendations designed to mitigate or eliminate current deficiencies.

There are also *three appendices*, which contain a short summary of the current legislative and regulatory situation for CRAs in the US, the mandate from the EU Commission and the list of the ESME members as well as a **bibliography** of our sources.

¹ ESME would like to thank all these representatives for their time and information.

General questions

ESME is asked to:

- Provide its views on the role of CRAs and the importance of ratings in the financial markets, and in particular, in the field of structured finance; and,
- Look into the functioning of the self-regulatory framework in the EU for CRAs, taking into account the new US Credit Agency Reform Act of 2006 which entered into force in June 2007.

1. Role of CRAs and importance of ratings

1.1. What are CRAs?²

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

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

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

1.2. Business models of CRAs

The three CRAs above make all their public ratings on issuers available to the market free of charge on their websites³, operating under the "issuer pays" model. Alternative business models, typically described as "investor pays", rely upon subscription revenues and thus the release of ratings to only those parties who have subscribed to that rating service. There has been a rapid growth in the number of structured finance transactions, which is reflected in the CRAs' revenues: CRAs currently earn approximately 50% of their revenue from structured finance ratings.⁴

A corporate⁵ would typically have two or three CRAs rating their debt and an annual fee is paid to each. In contrast, structured finance issuers would pay the bulk of the fee upfront with a modest annual surveillance fee. A portion of the up-front fee may be recognised on a deferred basis, where part is deemed to cover subsequent surveillance cost. Structured finance usually has more than one rating; exceptions include the use of securities in the repo market where the ECB only demands one rating. ESME's general view is that in principle, structured finance products should have more than one rating, unless there are specific commercial reasons for having just one. The increased number of rating opinions would improve the quality of the ratings, decrease the risk of conflict of interest and improve investor information.

² Throughout this document the term 'CRAs' mainly refers to the three biggest rating agencies.

³ Please see www.standardandpoors.com, www.moodys.com, www.fitchratings.com

⁴ CESR, *The role of credit rating agencies in structured finance – consultation paper*, February 2008, p.12

⁵ Throughout this document, the term 'corporate' includes banks and other financials

1.3. Meaning of ratings

1.3.1. Definitions

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

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

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

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

1.3.2 Differences between corporate vs. structured finance products

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

Corporate debt

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

Structured finance debt:

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

2. CRAs and regulation

2.1. Use of ratings

The ratings issued by the CRAs play an important role in regulation, specifically, in the risk weighting of banks' assets for regulatory capital purposes, such as for Basel II.

2.2. EU framework for CRAs

In the EU, CRAs are not specifically regulated, although they are subject to some direct or indirect review under the Capital Requirements Directive (see below).

EU assessment on need for EU regulation on CRAs

After the collapse of Enron, the ECOFIN in April 2002 requested the EU Commission to assess the activities of CRAs. As a result, during 2003 the EU Commission held several discussions on the subject in the European Securities Committee (ESC). Moreover, in February 2004, the European Parliament (EP) called on the EU Commission to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals to deal with CRAs. With technical advice from CESR⁶, the EU Commission published a Communication on 11 March 2006 setting out its position regarding CRAs.

It stated that within the EU, there are three Financial Services Action Plan (FSAP) Directives that are relevant to CRAs:

- (i) The Market Abuse Directive (MAD) tackling the issue of insider dealing and market manipulation. Commission Directive 2003/125/EC which implements the Market Abuse Directive states that *"credit rating agencies issue opinions on the creditworthiness of the particular issuer or financial instrument as of the given date. As such these opinions do not constitute a recommendation within the meaning of the Directive. However credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they appropriately disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate."*

There is however no requirement imposed on credit rating agencies or any established means of monitoring whether or how they seek to comply with this recommendation;
- (ii) The Capital Requirements Directive (CRD) providing for the use of external credit assessments in the determination of risk weights applied to a firm's exposures. Only the use of assessments provided by recognised External Credit Assessment Institutions (ECAIs), mainly CRAs, are acceptable to the competent authorities. The CRD allows Member States to recognise an ECAI as eligible in two ways: direct recognition, in which the competent authority carries out its own assessment of the ECAI's compliance with the CRD's eligibility criteria and indirect recognition, in which the competent authority recognises the ECAI without carrying out its own evaluation, relying instead on the recognition of the ECAI by the competent authority of another Member State⁷; and
- (iii) The Markets in Financial Instruments Directive (MiFID) – the issuing of a rating will normally not result in the CRAs also providing 'investment advice' within the meaning of Annex I to MiFID. However, CRAs that also provide investment services and activities on a professional basis may require authorisation.

⁶ CESR, *Technical advice to the European Commission on possible measures concerning credit rating agencies*, 30 March 2005 http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=3157

⁷ CEBS, *Guidelines on the recognition of External Credit Assessment Institutions*, 20 January 2006

Given that there are already three financial services Directives which cover CRAs, the EU Commission concluded that no new legislative initiatives were needed. Moreover, it felt confident that these Directives, combined with self-regulation on the basis of IOSCO's Code of Conduct ("IOSCO Code"), would satisfy any concerns. Nevertheless, the EU Commission asked CESR to continue to monitor developments in this area as well as CRAs' compliance with the IOSCO Code and report back annually. In the Communication, the EU Commission did warn that it may take legislative action if compliance with EU rules and the IOSCO Code were unsatisfactory.

CESR review of CRAs compliance with IOSCO Code

In its advice to the EU Commission, CESR developed a framework to review the implementation of the IOSCO Code consisting of 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;
- (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 occurs with a particular issuer in its market.

CESR published its first report on the CRAs' compliance with the IOSCO Code in December 2006 and concluded that the main CRAs generally comply with the IOSCO Code and noted that, consequently, CRAs' activities are more transparent. However, the report also identified various deviations from the IOSCO Code and recommended improving certain provisions.⁸ Given the report's main conclusions, the EU Commission maintained that the case for new legislation in this area remained unproven at this time.⁹

2.3. US regulatory experience

2.3.1. Background

The creation of the "nationally recognized statistical rating organisation" ("NRSRO") category occurred in 1975 when the US Securities and Exchange Commission ("SEC") wanted to use corporate bond ratings to help set minimum capital requirements for broker dealers. Since then US financial regulators have, in effect, been giving the CRAs the ability to determine what is and is not appropriate for their regulated financial institutions to hold to meet the regulatory requirements.¹⁰

These NRSROs were traditionally recognised as such by SEC Staff through the no-action letter process. However, the SEC has introduced a different registration process after adopting final rules on 26 June 2007 for NRSROs pursuant to the Credit Rating Agency Reform Act of 2006 ("the Act") enacted on 29 September 2006.

The express purpose of the Act is:

"to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."

The Act seeks to achieve these purposes through the following key features:

- requirements to provide detailed information to the SEC at the time of registration, most of

⁸ CESR, *CESR's report to the European Commission on the compliance of Credit Ratings Agencies with the IOSCO Code*, December 2006 http://ec.europa.eu/internal_market/securities/docs/agencies/report_en.pdf

⁹

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/28&format=HTML&aged=0&language=EN&guiLanguage=fr>

¹⁰ *Statement of Lawrence J White for the Committee on Banking, Housing, and Urban Affairs*, US Senate, 26 September 2007

- which is made public;
- requirements to update the registration information and to file financial statements;
- requirements to maintain procedures to prevent the misuse of material non-public information and to manage conflicts of interest;
- the prohibition of unfair, coercive or abusive practices.

The information requirements are wide-ranging and the SEC will therefore receive a considerable amount of information which it can examine, and it has made extensive record keeping rules so that it can judge whether the policies notified to it are being followed in practice. This information and review process, when combined with the public availability of much of the material provided to the SEC, provides a framework for greater scrutiny and accountability of the NRSROs.

Generally, the Act allows any firm that has been issuing ratings for three years to apply for the NRSRO designation. The Act also requires them to submit: (i) summary financial information; (ii) evidence of financial and managerial resources for the production of credit ratings; (iii) a list of their largest customers; (iv) recordkeeping to support the basis for the issuance and maintenance of credit ratings; (v) submission to periodic examinations; (vi) annual audited financial reports; (vii) policies and procedures to prevent the misuse of material non-public information; and (viii) disclosure and management of conflicts of interest. Four types of conflict are prohibited outright, whereas other types of conflict are prohibited unless disclosed and managed.¹¹ Further information on US regulation is contained in Appendix I.

Currently, there are nine NRSROs: AM Best; DBRS; Egan-Jones Rating; Fitch; Japan Credit Rating Agency Ltd; LACE Financial Corp; Moody's; Rating and Investment Information; and S&P.

2.3.2. Powers of the SEC

It is clear that the legislation gives the SEC the responsibility for promoting competition in the credit ratings industry and for policing CRAs' activities, in particular, conflicts of interest. However, the SEC's authority does not extend to the regulation of the substance of the credit ratings or the procedures and methodologies that CRAs use to determine their ratings. In the words of SEC Chairman Christopher Cox, "... the law declares it is not our role to second-guess the quality of their ratings."¹²

The SEC is currently conducting a non-public examination of CRAs that are active in rating RMBS, in particular, whether CRAs were unduly influenced by issuers and underwriters to publish a higher rating. The President's Working Group on Financial Markets is also examining the role of CRAs in lending practices, how their ratings are used and how the repackaging and the securitisation process have changed the mortgage industry. The SEC is taking a leading role in this study.

2.4. Conclusion of EU and US approaches

As detailed above, CRAs operate in a self-regulated environment in the EU with CESR playing an oversight role, whereas in the US the SEC has real supervisory powers. It is too early to judge the effect of the US legislation. It is possible that the requirement that the credit rating agencies describe their procedures and methodologies to determine credit ratings and document them internally, when combined with the ability of SEC staff to inspect the procedures and methodologies and determine if they have been followed, could produce a consistent and higher quality approach, although nothing can yet be determined in this respect.

Given the global nature of the business of CRAs and the existing US law, we have doubts as to whether the development of a separate EU law would produce any particular benefits. We think it is important that CRAs are subject to a global approach to their business and do not become distracted by similar laws which nevertheless have differences across a range of jurisdictions. We think that regulatory cooperation in this sphere is essential to avoid duplication of effort. Therefore, ESME believes that the SEC

¹¹ <http://www.sec.gov/rules/final/2007/34-55857.pdf>.

¹² US Treasury, *A Hearing of the Senate Banking, Housing and Urban Affairs Committee*, 26 September 2007

should be invited to join the advisory group that ESME recommends being established (see p. 22 of this paper).

3. Genesis of the Turmoil in the Credit Markets

The crisis of confidence in the credit markets is generally agreed to have originated in the US subprime residential mortgage market. The subprime market, which refers to the higher risk borrowers (measured by the FICO credit score) who typically had some delinquency/default experience in their credit history, had grown rapidly to a point where in 2007 some estimates suggest it reached a total size of US\$1.4 trillion outstanding, representing around 15% of the total US residential mortgage market.

A core feature of a subprime residential mortgage is that there is a 'teaser' interest rate at the outset which over two to three years rises rapidly to a punitive rate (typically in excess of 10%), which is designed to incentivise the borrower to refinance. In the past, typically 90% of a subprime portfolio would be amortised or repaid within three years. The following summarises the background to the crisis in the US subprime market, the role of the CRAs and how it then affected other credit markets.

- ◆ The substantial reduction in interest rates in 2002 post-9/11 boosted demand disproportionately from this subprime market segment. Debt service capacity appeared a lot more attractive with the fall in interest rates.
- ◆ The benign economic climate, with continuing home price appreciation, further boosted demand.
- ◆ Competitive forces pushed up loan-to-value (LTVs) substantially, some approaching 100%, due to falling interest rates.
- ◆ While most of the business was being originated by brokers and banks the vast bulk of the mortgages did not stay on the banks' balance sheets, but were pooled and securitised in the capital markets with ratings issued by the CRAs. The lack of a 'continuing ownership interest' may have reduced the incentive of originators to be concerned regarding the long-term quality of the assets.
- ◆ The holders of the securities were a wide range of global institutional investors (including SIVs and hedge funds), many of whom just 'bought the rating'. Over 80% of the subprime securities issued were AAA.¹³ The investors had a long successful run in this market which was paying a premium for the higher risk, but which historically had not crystallised as a real higher cost. The subprime assets did not meet the criteria to be securitised with FNMA (often referred to as Fannie Mae) and FHLMC (often referred to as Freddie Mac).
- ◆ In 2006, when the warning signs about the deteriorating market conditions were becoming more pronounced, the tightening in lending standards that would normally be expected at borrower level in response did not happen because of the voracious and growing appetite in the capital markets for this paper. Indeed, ironically there was a further loosening of lending standards in 2006 with a significant increase in the percentage of borrowers with no or limited documentary evidence of income. The CRAs, who had concerns which they had articulated largely from 2005 and would have been aware of the deterioration in the underwriting standards, continued to rate new securities but on the basis of much tighter credit enhancement requirements.
- ◆ The fall in house prices was the critical catalyst which affected the main source of repayment, i.e. the refinancing market. Refinancing ultimately became impossible because of the continuing fall in house prices. The refinancing market for subprime mortgages effectively dried up in Q3 2007. It was not economically viable for these borrowers to live with the increasingly punitive interest rates and consequently default rates rose dramatically.
- ◆ Fraud was also a feature, but was not the fundamental problem.
- ◆ The increasing level of bad news prompted many holders of the securities to sell. The hedge funds were foremost in this regard as they had to respond to an increasing number

¹³ FT, *Lex Column: As simple as ABX*, 6 December 2007, chart

of their investors wanting to realise their investments. Additionally, they faced pressure from their banks to reduce their borrowings as their covenanted coverage ratios began to be triggered. The selling pressure pushed down secondary market prices dramatically, e.g. BBB subprime securities issued in Q4 2006 reached a secondary market price of 30c by the end of 2007. In the case of AAA subprime securities issued in Q1 2007 the secondary market price fell below 70c on the ABX index in Q4 2007. In response, hedge funds began to release liquidity by selling their most liquid and more highly rated non-subprime investments, which in turn pushed down secondary market prices on all securities. Investors began to lose confidence in the CRA rating 'brand', a fundamental factor which underpins confidence in the financial market.

- ◆ The spiralling crisis of confidence spread globally and across all credit asset classes. This was compounded as banks became increasingly focused on preserving liquidity; they began to cancel interbank lines and became extremely cautious and conservative in taking on new credit exposure.
- ◆ In December 2007, a leading investment bank estimated that the discounts in the ABX market indices implied total subprime losses of US\$400bn or cumulative losses on the underlying mortgages of 30% (the worst record to date was 7 to 8%). This 'implied' that one in three people defaulted and there were no recoveries on the forced sale of homes, or that every person defaulted and recoveries were just 70%.¹⁴
- ◆ The CRAs do not accept secondary market prices as an indicator of the true scale of the problem and say they are only concerned with actual defaults and actual loss rates. However, the secondary market prices reflect the anticipated sharp increase in the incidence of default following the full impact of the ratcheting interest rate adjustments to be experienced between now and 2010. It is relevant to point out that, while the CRAs reflected their growing concerns through 2006 and 2007 about the subprime market by applying more conservative criteria to secure particular ratings and by publishing warnings to the markets, the subsequent downgrading experience on these securities was in a short time-scale nonetheless unprecedented. For example, the transition tables of the CRAs indicate that between c. 60% to 70% of the 2007 vintage of first lien subprime securities were downgraded by Q1 2008.¹⁵

¹⁴ FT, *Lex Column: As simple as ABX*, 6 December 2007

¹⁵ See transition tables of Moody's and Fitch. S&P do not provide figures on a disaggregated basis.

Responses to Questions

Q1. Does ESME consider that the particular oligopolistic market structure influences competition amongst the CRAs in a way that may have a negative impact on the quality / integrity of the rating process?

New entrants to the credit rating business face the particular challenge of having to develop and demonstrate a track record to acquire credibility with investors which is necessary to persuade issuers to buy their rating service. Additionally, the oligopolistic CRA market structure, which reflects the dominant market position of the major agencies, a couple of which have over one hundred years of experience, makes it more difficult for new players to gain entry.

In considering whether this state of affairs has a negative impact on the quality and integrity of the rating process, it is appropriate to look at recent experience. While the major rating agencies issued papers expressing concern regarding the evolving subprime market, they had, to a large extent, a consensus position and did not anticipate in their ratings the scale of the deterioration that ultimately transpired and led to the crisis of confidence in their ratings. Some market feedback suggests that the incentive for an individual CRA to take the more conservative stance on structured finance was reduced because it could have had a dramatic impact on the flow of new structured finance ratings and related revenues, i.e. there was a substantial financial disincentive in the short term to 'break ranks'. It is not possible to demonstrate that having more competitors would definitely have materially altered what happened. However, competition can bring of a greater diversity of thinking and opinion perhaps on the back of a different business model as competitors seek to differentiate their offering. It therefore at least opens up the significant possibility that the underlying flaws and issues in the subprime market would have been identified in a more coherent and timely manner and accordingly communicated to the market.

Whilst there are benefits in having major rating agencies, ESME believes that the oligopolistic structure could have contributed negatively to the quality/integrity of the rating process.

The recent damage to the reputation and credibility of the existing rating agencies may well reduce the effective barrier to entry for new players. However, it is a difficult and slow process for a new entrant to become an established and credible player. ESME believes that steps should be taken to encourage and facilitate the entry of new competitors. One option would be to encourage the development of specialist niche CRAs that would focus on specific industrial segments or asset classes to differentiate themselves from the existing players. Another option would be to encourage new CRAs to carry out unsolicited ratings to help build market awareness and credibility.

Encouraging more CRAs to operate would also require vigilance against "ratings shopping", although issuers who engage untested CRAs with questionable standards are unlikely to be taken seriously by the market.

Q2. What are ESME's views on the quality of ratings and does ESME consider that rating methodologies are sufficiently robust, in particular for structured finance ratings? Does ESME consider that CRAs staff's understanding of the rapidly and growing complex structured finance market is satisfactory?

CRAs have a long track record and good credibility in rating corporates, based on the historic level of default statistics, which suggest that their methodologies for corporates are robust.

For structured finance, at least for the subprime market, recent experience indicates an inordinate level of downgrading shortly after the initial rating, which reflects unfavourably on their methodologies for structured finance. This data appears to indicate that the methodologies were inadequate and suggests that the CRAs staff did not have an adequate understanding of the structured finance market, or at least in the subprime residential mortgages market.

The poorer performance of certain asset classes within structured finance would appear to reflect a combination of factors including the following:

- The more systemised approach with greater weight given to the models than justified by the available historic data. CRAs started issuing ratings for mortgage-backed securities in the mid-1970s and only began rating cash CDOs in the late 1990s and synthetic CDOs in the early 2000s.¹⁶
- Inadequate consideration of concentration risk and its implications.
- In the case of subprime the potential 'cliff edge' consequences of the combination of the double/triple leverage inherent in the securities and operating at the high risk end of the risk spectrum.
- Following on the more systemised approach the inadequate consideration given to the macro perspective in contrast to the practice in the corporate rating process.
- Possible understanding gap between the 'quants' and senior management.

Models should play a part in the rating decision, but not the only part and a balance should be struck between the model and qualitative assumptions in the decision process.

Q3. Does ESME consider the rating methods, including the assumptions within these methodologies, sufficiently transparent?

While the CRAs have greatly increased the volume of communication on their websites on rating methods and assumptions to a lesser extent, this information is presented in a manner that typically does not facilitate easy access and understanding on the part of the investors, in the absence of direct dialogue with the CRAs. It is probably fair to say that transparency was patchy and inconsistent in the past; transparency on critical issues and associated information was not necessarily a priority, e.g. there was limited communication on the 'refinancing risk' in the subprime market. The quality of websites also varied according to the agency, with some better than others.

The CRAs have recently publicly committed themselves to an enhanced standard of transparency which is interpreted to mean more relevant information in a style that will facilitate easier access and adequate understanding. Priority focus should be on the rating methodologies, the key risk factors and the key assumptions for the different asset classes and the individually distinct sub-asset classes (please see recommendations in A on pp.18 and 19 and C on pp.20-21).

However, we believe caution needs to be exercised to avoid giving the impression that total transparency is the perfect scenario. Such a level of transparency (e.g. giving the precise weights attached to all the risk factors used in the model) may be counterproductive and misleading for the following reasons:

- It implies a level of science in rating that is neither appropriate or realistic;
- It understates the qualitative/subjective input to the rating (more important going forward); and
- It can facilitate 'ratings gaming'¹⁷.

Q4. Have CRAs made sufficiently clear how the meaning of structured finance ratings differs from corporate ratings. If not, would it be desirable that CRAs make a clear distinction in terms of rating "labels" between corporate and structured finance ratings?

¹⁶ IOSCO, *Consultation Report: The Role of the Credit Rating Agencies in Structured Finance Markets*, March 2008, pp.8-9

¹⁷ "Ratings gaming" occurs where an issuer uses his understanding of a CRA's criteria to optimise the pooled portfolio while still staying officially within the criteria – which reinforces the need for qualitative review (e.g. in rating committees) relative to a purely quantitative model-driven approach.

The CRAs have indicated that they would like their ratings to be comparable across asset classes, but although the meaning of their corporate and structured ratings is “*broadly similar*”, similar does not mean “*the same*”.¹⁸ The CRAs have not adequately communicated how structured finance ratings differ from corporate ratings and it would be helpful if CRAs are more transparent about the differences.

As CRAs state that their ratings have a similar meaning across asset classes, the average long-term default experience through the economic cycle should be similar for corporate and structured finance. The recent substantial disparity in the downgrading experience has challenged the view of the CRAs at least in relation to the subprime residential mortgage structured finance securities.

It is appropriate that CRAs distinguish structured finance ratings from corporate ratings so as to provide information on the particular attributes and vulnerabilities of structured finance, other than credit risk which is what the core rating is designed to address. Recent market experience points to the reality that certain structured finance asset class securities evidence behavioural characteristics that are different from similarly rated corporate securities, i.e. bigger and more rapid rating transitions. This reflects a combination of factors including structural features, concentration risk, complexity/opacity and illiquidity which expose these securities to greater volatility, i.e. greater potential transition, which can be up as well as down.

In considering how best to enlighten the users on the differences it is considered inappropriate to adopt an entirely separate scale for structured finance securities as it could cause much confusion. Ultimately all securities should be amenable to comparison in terms of default probability and this warrants a single scale. However, we believe that it is appropriate and necessary that the CRAs and the sponsors inform the users of non-credit factors such as liquidity and volatility that can influence the performance of structured finance securities. The use of a ‘label’ to measure the greater likelihood of rapid and large rating transition, if well designed, should add considerable value in the communication process (see recommendation C6, p.20).

Q5. Does ESME consider that the level of transparency regarding rating changes should be improved? In particular, are the reasons for rating changes sufficiently clear?

The level of transparency regarding rating changes for corporates is considered satisfactory. The reasons for the rating change are usually well explained. Furthermore, the way that CRAs detail clearly the key risk factors/drivers which could give rise to a future upgrades or downgrades is very helpful for the user of ratings to get a sense of the sensitivity of the rating going forward.

For structured finance, the reasons for the rating change are not always clear given the opacity of structured products and, in certain instances, the scale of rating adjustment, in terms of the number of notches, is not adequately explained. (Please see recommendations in C on pp.20-21)

Q6. As regards the timeliness of rating changes, does ESME consider that CRAs have adequate resources for ongoing surveillance of existing ratings? Does ESME consider that CRAs need to improve the timeliness of rating decisions and specifically is the cycle of review appropriate and adequate for structured finance in view of the particular market dynamics?

The cycle of review for corporates appears appropriate and adequate and in general, the timing of rating decisions appears reasonable.

For structured finance, the resources of the CRAs have been stretched following the rapid growth in new ratings and the exponential growth in deteriorating structured finance securities. This has contributed to a delay in the re-rating decisions. The CRAs have been seeking to address this issue by increasing the resourcing in the surveillance function. However, the criticality of timely re-rating given the scale

¹⁸ “Across corporates, sovereigns, and structured finance, we seek to ensure to the greatest extent possible that the default risk commensurate with any rating category is broadly similar. “Similar”, however, does not mean “the same”, S&P, *The Fundamentals of Structured Finance Ratings*, 23 August 2007, p.10

of the relevant securities warrants a more systematic approach to achieve a more 'real time' reflection of the underlying risk. The substantial homogeneity of the underlying risk in the individual asset classes facilitates the extrapolation of identified deterioration across the portfolio. However, it does require efficient IT to systematically capture all the necessary performance data, including relevant regional indices of security value, where available. Where well-designed it can systematically feed updated information on the common risk factors to the underwriting models used in the initial rating and thereby identify those cases in the portfolio where the current model representation of the risk has moved outside the range implied in the current rating; these cases can then be considered on a prioritised basis for rerating by the rating committee.

Q7. Does ESME believe that rating analysts should be required to obtain a formal qualification in credit to agreed standards before practicing as such?

ESME considers there is merit in developing a specialist professional qualification as the possession of such a qualification would demonstrate a core level of knowledge and competence in credit rating.

However, while such a qualification might be useful and beneficial, it should not of itself be necessary or sufficient for a CRA to be satisfied as to the competency of an analyst. The practice of recruiting from a wide cross-section of academic and professional backgrounds brings a diversity of expertise and perspectives which is to be encouraged.

Q8. Does ESME believe that the rating agencies respond adequately to the increased risks of future default arising from changed market circumstances which reflect in current delinquencies and foreclosures?

The recent experience with subprime residential mortgages indicates that, while the CRAs flagged some negative developments and deterioration mainly in 2005/2007, they did not envisage the scale of the ultimate deterioration in that market. This appears to have been evidenced by the fact that the new subprime residential mortgage securities, which they rated in 2006 and 2007, experienced an inordinate level of downgrading quickly thereafter. The inherent double/triple leverage in structured finance, together with the fact that the subprime assets were at the outer end of the risk spectrum, was a combination that always had potential 'cliff edge' consequences in the event of material underlying deterioration. The actual deterioration in terms of increased subprime mortgage defaults was dramatic and the consequent impact on the structured finance securities was even more dramatic.

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

There is limited evidence available to suggest that consideration was given to the particular concentration risk inherent in a pool of subprime residential mortgages, i.e. the primary source of repayment was the 'refinancing' market which ultimately dried up and proved fundamental in influencing the scale of default/loss in the crisis that ensued.

The CRA philosophy of "rating through the cycle" may have encouraged a bias where non-cyclical deterioration was sometimes viewed as cyclical change, which would reverse over time. This may have been a contributory factor in the 'misreading' of subprime, which resulted in a delayed recognition of fundamental deterioration and reflection thereof in the ratings.

The adequacy of the CRA response to the exponential growth in deteriorating structured finance securities appears to have been constrained by: a) the stretched surveillance resources; and b) the lack of IT capacity to systematically extrapolate the identified deterioration across the relevant asset classes to en-

able a timely determination and representation of the rating consequences across the portfolio.

Q9. Does ESME believe it is appropriate that a rating agency is not obliged to verify information via due diligence or to conduct an investigation or review to establish the integrity of core information used in the rating process?

Structured finance necessarily relies on CRAs because investors cannot on their own evaluate the securitised pools of financial assets that structured finance creates as the necessary information is not available to them. For example, while a sophisticated investor might be able to determine the creditworthiness of the bonds of a corporate by examining the firm's financial statements and other public information, the investor has no corresponding ability to assess the risk level of a sub-prime mortgage pool backing a security and must rely substantially on the rating given by the CRA. This underpins the need for CRAs to be satisfied regarding the integrity of the core information and data used in the rating process of pooled asset structures.

Following the crisis of confidence in ratings and the collapse in the volume of new structured finance issues we believe it is essential that CRAs accept that they have the responsibility to ensure comfort is given to investors on the integrity of the information which underpins their ratings. This would require independent and robust due diligence to be undertaken. In this regard the CRAs could either:

- a) Obtain assurances from the sponsoring bank that it has undertaken appropriate due diligence, in circumstances where the sponsoring bank is deemed credible and capable of honouring their obligations under their indemnities; or
- b) Commission a suitable external party, e.g. one of the internationally recognised accounting firms, to undertake the due diligence, or
- c) Undertake the due diligence themselves.

Whilst concern has been expressed about the cost of this due diligence it needs to be viewed as an unavoidable cost in re-establishing confidence in this market.

Please see recommendations in B7 on p.19.

Q10. Should rating agencies put in place more automated and objective systems, based for example on the changing value of underlying assets / cash flows, to facilitate more dynamic rating?

Quantitative market implied rating systems which estimate on a dynamic basis a probability of default off the market price of the ordinary equity, bonds and credit default swaps are a welcome and important development in the rating process and should be encouraged. The equity derived probability of default has probably the most credibility but obviously is limited to publicly quoted companies. KMV (now owned by Moody's) has been doing work for nearly 30 years on equity derived probability of default estimates; empirical evidence suggests it has been a better predictor of default than the rating agencies.

It is not considered appropriate for the CRAs to use market implied ratings to determine an issuer's rating in an automated manner because of the potential daily volatility in the rating. However, the market information reflected in the price is considered a valuable input into the rating process, if only to challenge the 'status quo' thinking and is strongly recommended. Disclosing market implied ratings for corporates with a focus on the gap with the CRA rating, which can be interpreted as an indicator of the possible next move in the official rating, is a good practice.

Unfortunately the scope to apply to structured finance appears limited because there is no equity price and secondary market prices tend to be driven off market indices of value. These market indices, based on individual quarterly vintages, can change significantly on a small volume of transactions and are not

considered to be reliable proxies for the true value of individual security pools.

However, as set out in the answer to question 6, there is scope to adopt a more systematic approach to achieve a more 'real time' reflection of the underlying risk in the surveillance and consequent re-rating process. Whilst the changing value of the underlying real estate asset values in the pool may not be readily available there should be significant value in e.g. the regional indices of residential prices ; it is likely to be more of a 'leading' indicator than some of the more traditional measures, e.g. delinquency and default, which tend to be more 'lagging' indicators. However, it does require efficient IT to capture all the data and, where well designed and integrated with the initial underwriting model, can produce dynamically updated ratings for consideration by the rating committees.

Q11. Should rating analysts be required to serve "cooling off" period before working for a client (i.e. "gardening" leave)?

In short, staff take their structuring knowledge and experience to their new employers and they replicate what they have learnt for their new employer. This knowledge cannot be erased with gardening leave. However, it is appropriate that CRAs insist on notice periods being served either in or outside the office. Any 'cooling off' period longer than the notice period may not be legally sustainable.

CRAs should institute appropriate "look back" reviews to ensure the integrity of any ratings by departing analysts.

Q12. How does ESME believe that risks of conflicts of interest arising in the interaction between issuers/arrangers and CRAs might be more effectively mitigated? In particular, for example, does ESME believe that the independence of the rating assessment process should be underpinned by having a direct reporting line to a committee of independent directors on the rating agency boards?

Corporate and structured finance products are very different products. By their nature structured finance products typically require intensive interaction at the outset in establishing the rating. With corporates, there is typically a given level of debt and the rating is determined in the context of the business and financial risk. With a structured finance product the pool of assets is the given and the focus is either on maximising the aggregate debt level (i.e. the overall leverage on the pool) or alternatively how to achieve a targeted debt rating, e.g. how to achieve a Aaa/AAA rating and to consider the credit enhancement requirements that are required in that regard. The level of dialogue involved in this iterative process can create the impression that the CRAs have become very involved with the issuer/sponsor in shaping the structure of the structured finance security. External comment sometimes suggest that this relationship can be perceived as becoming advisory in nature and being too close, particularly in view of the fact that the profitability of a CRA is heavily dependent on the flow of its new structured finance ratings.

Effective management of the conflict of interest issue requires determined action on a range of fronts to ensure that decision-making conforms to the highest standards expected of a CRA. In essence, there needs to be strong corporate governance underpinned by a robust culture to influence the decision-making environment in a way that consistently evidences the imperative of quality standards; the detailed steps involved in this are incorporated in the Conclusions & Recommendations.

ESME believes that the integrity of the rating process would be enhanced by having a strong Policy function whose stature and independence would be underpinned by having a direct reporting line to a committee of independent directors of the Board of each CRA. The Policy function would have responsibility for policy/core criteria, approval of new models, new product approval (defined to include material variation on existing products) and quality assurance, i.e. review of actual standards across the organisation.

Please see recommendation A on p.18)

ESME recognises that individual CRAs might need to adapt this recommendation taking into account their own particular corporate structure.

ESME's conclusions and recommendations

The performance of the CRAs in rating corporates, which reflects nearly 100 years experience, is considered satisfactory. There have been a number of high profile collapses which have usually prompted criticism of the CRAs but, as 'outliers', they do not undermine the overall integrity and value of the corporate ratings.

However, in our view, in the area of structured finance the performance of the CRAs has been unsatisfactory. The size of the problem has been greatly increased by the scale of funds in the different structured finance asset classes. This ultimately resulted in a global crisis of confidence in the rating brand and the credit markets generally. Accordingly, the conclusions and recommendations address the problems in the area of structured finance.

Individual CRAs have in the recent past announced changes (including those contained in a recent discussion paper drafted by the larger CRAs) to enhance the integrity of their rating processes; some of these changes have already been implemented, some are planned to be implemented and some are out for market feedback. ESME welcomes these enhancements. There is some overlap between these changes and what ESME is recommending hereunder as the market standard; so in some cases the recommendation may/will have already have been implemented by one or more CRAs.

While many of the recommendations are individually quite basic, history has shown that many of the problems in other credit risk businesses (e.g. banks) arise because the 'basics' do not get the required priority, particularly at a time of rapid growth and market excess. Some of the recommendations, which in normal times might be considered excessive and unnecessary, reflect the urgent need to take every possible action to restore confidence in the rating 'brand' and the global credit markets; it also recognises the unique role of the CRAs as the custodians of the ratings on US\$40trn of global debt.

If some of the recommendations hereunder do not fit the particular structure and circumstances of a CRA then they should be adapted in a manner that does not dilute the substance and spirit of the underlying points.

A. Analytics / Policy

Individual CRAs have a methodology and set of criteria for each discrete asset class which are primarily concerned with the 'means' by which the rating is determined. There would be merit in having a separate policy paper for each distinct asset class, which would be regularly updated and accessible for investors. This would provide the strategic overview and the CRA policy position on the asset class, e.g. subprime residential, and would essentially provide the strategic and macro underpinning for the methodology and micro criteria used in the rating of individual cases. It would provide a valuable and updated strategic perspective to the rating committee members and would facilitate a focussed periodic review and updating of each CRA's policy position in respect of individual asset classes. The policy would incorporate and address, inter alia, a historic perspective on the asset class including resilience through cycles, distinctive risk characteristics, key risk issues and a particular focus on risk concentrations in structured finance. It should facilitate a more integrated connection between the macro and micro perspective in the rating process.

It is quite clear that the analytics, which are fundamental and central in the rating process, were inadequate and unsatisfactory in structured finance and subprime residential mortgages in particular. The issue of risk concentration, which is fundamental in structured finance, did not get the priority it deserved. There also appeared to be excessive reliance on risk models in the rating decision-making process in an area of business where there was limited underpinning history and data.

1. The policy template should elevate the priority given to risk concentration in all its guises as the critical input into the determination of the 'worst case' scenarios. Such scenarios should take

account of relevant historic experience and robust forward looking thinking.

2. The independence, ownership and accountability for Policy is a critical factor which is addressed under 'Governance'.
3. Caution is recommended in the use of models, in the absence of all relevant risk factors/variables being incorporated therein with adequate historic underpinning. To the extent that models incorporate the 'credit logic' of the best analysts they have a positive role to play as an input to decision-making whilst not being allowed to pre-empt decisions. The greater use of models in structured finance may have induced an excessive mechanistic approach without the proactive forward looking macro perspective which is associated with the corporate rating process.
4. While the CRA philosophy of 'rating through the cycle' has merit in principle it is important that the dangers of wrongly categorising change, in this regard, as cyclical are fully recognised. Assuming that non-cyclical change reverses in time will result in overly generous ratings

B. Governance

Good corporate governance is important in every business but especially important in the rating agency business because of the potential trade-off between quality standards and profitability. Given the unique and fundamental role of the CRAs in the financial markets it is essential that they would have corporate governance standards that conform to the best standards in the world of business.

1. The independence of the Policy function is imperative and needs to be recognised as such in the corporate governance of each CRA. CRAs should have an independent Policy function with clearly delineated responsibilities. It should be accountable for policy, core criteria, approval of models, new product approval (defined to include material variation on existing products) and quality assurance, i.e. review of actual standards across the organisation.
2. The fundamental importance and independence of the policy function should be recognised in the organisation structure; the primary reporting line of the head of this function should be to a Policy sub-committee of the Board (comprising a majority of non-executive directors) with a separate line to the CEO for operational matters. The key policies should be reviewed by this sub-committee on a cycle basis.
3. Recognising the responsibility of the Board and non-executive directors, in particular, to ensure there is effective governance it is recommended that: a) at least 50% of the non-executive directors of each CRA would have relevant expertise and experience in the risk business; b) their compensation be essentially a fixed fee, i.e. they should not qualify for performance linked compensation, e.g. share options; c) there be a fixed term of office lasting up to five/seven years; and d) to the extent it is not already in place a statement of role and expectations should be formalised for all the Board members.
4. The role of CEO and Chairman of each CRA should be separated so that there is a non-executive chairman, a fundamental ingredient in a robust system of corporate governance. ESME recognises that execution of this recommendation depends on the respective legal / corporate structure of each CRA, but the outcome we seek is clear.
5. The 'quality assurance'/review function in structured finance should be resourced with people who are independent of the people doing the initial rating.
6. There should be systematic rotation of lead analysts with a maximum period in any one area of responsibility.
7. CRAs should accept that they have a responsibility to be satisfied with the integrity of the information on the pool of assets they are rating. CRAs should either undertake due diligence themselves or ensure it is undertaken by an appropriate and suitable party (refer to

answer to question 9 on p.15).

8. Rating analysts should not be involved in making proposals or recommendations regarding the creation or design of securitisation products.
9. CRAs should not undertake advisory or consultancy work for an issuer they are rating.
10. A CRA should disclose whether any one issuer/originator or sponsoring bank makes up more than 10% of the CRA's revenue derived from the issuance of ratings.

Some of the above may require adaptation to take account of: a) smaller CRAs; b) those countries where there are legislative requirements governing board structures; and c) where there are different corporate structures (e.g. CRA having no board), without diluting the substance and spirit of what is recommended.

C. Communication / Transparency

A commitment to transparency and to better communication is a necessary first step to restoring trust and confidence. So there is a need to share more information in a more effective manner so that the users of credit ratings can better understand how the ratings are determined. In certain areas of our recommendations hereunder this will require the co-operation of the issuers/sponsors:

1. There should be a priority focus on sharing information on the key assumptions, including, e.g. 'expected loss' with disclosure also of historic 'worst case' and 'break-even' credit loss for different tranches.
2. Include 'what if' scenario analysis to convey an understanding of the sensitivity of the rating to adverse or positive events. The identification, as in the corporate ratings, of key risk factors/developments which could trigger a downgrade or upgrade would be very beneficial to the users and would constitute an appropriate discipline on the CRAs.
3. Simplify access to the rating methodologies, models and criteria in a manner which recognises the different user groups in terms of technical capacity and understanding.
4. Agree with other CRAs and market participants the minimum core data and information that should be disclosed on a pool of assets being securitised (and required as a market standard) to enable the informed investor undertake a proper evaluation of the risk. This should also facilitate more 'unsolicited ratings', which would be a welcome development.
5. There should be disclosure of the 'retained interest' of the originator, if any, in the pool of assets being securitised and the originator's obligations and indemnities.
6. CRAs should inform users of the greater potential volatility with structured finance securities and the reasons therefor. Consideration should be given to using a 'label'/rating suffix to measure and communicate the inherent volatility, i.e. the likelihood of rapid and large rating transition.
7. Develop an early warning indicator to communicate to investors that, where a key risk quality measure (e.g. delinquency or default) of an issue differs from expectations, the CRA has triggered a full review or may do so. It is also recommended that CRAs introduce 'outlooks' for structured finance ratings which, as in the area of corporate ratings, would serve as an early indicator of possible next movement and would help markets to adapt smoothly, with less price shock effects.
8. Re-rating must be done on a more timely and dynamic basis across the entire structured finance portfolio. This should incorporate, inter alia: a) the application of any material change in policy across the entire population of related securities to determine the rating changes arising; and b) the application across an asset class of the broader implications from the particular extrapolated loss rates arising on evolving delinquency/default experience in specific securities. The appropriate systems and resourcing must be in place to ensure this can be done on a timely basis.

9. CRAs should commit to better educating users on the meaning of a rating, what it does not measure, how ratings are determined and the rating surveillance / review processes operate. The user manuals need to be designed in a way that recognises that investors are comprised of a disparate group with widely varying levels of technical capacity to understand the rating complexities.

D. Performance Measurement

The major CRAs agree they should help to establish a centralised repository for ratings performance studies to allow easier market comparison among CRAs. Going the next step and having an agreed measurement framework to evaluate performance/success would greatly enhance user understanding and enable them to differentiate the CRAs.

1. It is recommended that the major CRAs, with input from IOSCO and other relevant market sources, should agree a set of measurement principles and framework which would become the market norm for evaluating the performance and success of rating agencies. It is suggested that the framework should incorporate, inter alia, 'rating accuracy', the incidence of downgrades relative to a benchmark 'norm' and the average downgrade in terms of number of notches moved.

E. Culture

Conflict of interest, arising from the trade-off between quality standards and profitability, is a general feature of risk businesses and represents a constant management challenge. It has been a particular feature of the rating agency business because of the exceptional and disproportionate impact on P/L of the flow of new structured finance ratings issued. The importance of the issue warrants strong management controls and careful attention. However, in any business, the prevailing culture is a key factor in differentiating how companies, who otherwise are similar, actually perform in practice. Members of the CRA top management, who ultimately have responsibility for shaping the culture in their organisations, assert they have robust cultures which reflect the pre-eminence of rating quality/standards. While the genuineness of this assertion by senior management is not questioned the key question and issue is whether management is fully aware of the actual culture that prevails in practice and drives actual behaviour, including decision-making, throughout their organisation. The criticality of culture in influencing the decision-making environment and actual performance warrants CRAs taking steps to ascertain and understand the actual culture that prevails in their individual organisations. This is the context for the recommendations hereunder:

1. Each CRA should undertake a survey of their actual culture at least annually and share the results with their Board. This survey should focus on the norms, values, behavioural practices and attitudes that prevail throughout the organisation.
2. Consideration should be given to changing the mix in compensation of the CRA top management towards a higher fixed salary component and substantially reduced performance related incentives.
3. The committee decision-making process is represented by all the CRAs as the bedrock which controls and underpins the integrity of the rating process. ESME acknowledges this, but because of the central importance of this process, ESME recommends that consideration needs to be formally given to whether the shared responsibility and accountability that characterises this 'consensus' approach is the best and most robust for the rating and associated policy decision-making processes. The desired outcome is the discipline that results from clear accountability.
4. The role of the non-executive directors on the Board of CRAs in particular, is especially important in overseeing and influencing the integrity of the rating process. The recommendations in

B3 are relevant in this regard from a cultural perspective.

F. External Regulation / Oversight

The resolution of the current crisis of confidence in the ratings industry rests primarily with the CRAs themselves. There is no regulatory panacea in isolation. In fact, full formal regulation may be counter-productive as it might be seen by users in the market place to imply a level of official endorsement of ratings which is neither justified nor feasible. ESME does not consider it is possible for regulators to put themselves in a position where they can give that level of endorsement. Even the SEC's authority in the US does not extend to the regulation of the substance of the credit ratings.

Our view overall is that the incremental benefits of regulation would not exceed the costs and accordingly is not recommended. However, there are two qualifications to this conclusion:

- That an enhanced self regulatory model, as recommended hereunder, is made to work and is seen in the market to be effective.
- That the existing CRAs facilitate in a substantive and constructive way the reduction in the barriers to entry thereby facilitating the establishment of new CRAs; and

In addition, it is assumed that an effective accommodation can be agreed between the SEC and the EU, whereby the EU can leverage their regulatory approach to this global business without the need for duplication of regulatory effort.

It is recommended that:

1. A more robust and enhanced IOSCO code should be adopted with appropriate and adequate transparency around CRA compliance. The enhanced Code should incorporate the recommendations in the recent IOSCO paper (March 2008) subject to discussion on certain practical implications of a small number of the recommendations, e.g. 2.8(c) relating to CRAs disclosing ratings shopping cases. The enhanced Code should also incorporate relevant points arising from the recommendations contained in this paper.
2. CESR's review of the CRAs' adherence to the IOSCO Code should be bolstered by:
 - a. Commissioning, in conjunction with the CRAs, an external annual review and report on the adequacy of corporate governance in each CRA. The corporate governance that prevails in each CRA has a critical impact on the internal decision-making environment which influences both policy and rating. The criticality of the actual culture that prevails in this regard should also be recognised by incorporating the survey of the culture in this annual work.
 - b. Forming an advisory group to advise CESR of: (a) significant developments, trends and issues in the credit markets which are relevant to the activities of the CRAs; and (b) any rating trends/issues which are prompting concerns. The ultimate objective in forming this group is to provide CESR with an informed market perspective to enable it discharge its review role effectively. Membership of this group would comprise investors/users, issuers, originating banks, sponsoring banks, credit experts, academic risk experts and the SEC. The CRAs would not have members on the group, but could be requested to attend and would have the opportunity to present on pertinent topics or issues.

Appendix I

US REGULATION OF CRAs

(The following paragraphs are based on the final SEC rules and explanatory material)

The U.S. Credit Reform Agency Act 2006 (“the Act”); SEC powers

The Act provides a voluntary mechanism for credit rating agencies to register with the Securities & Exchange Commission (“SEC”) and provides the framework for the SEC to make detailed rules. A firm which is registered qualifies as a “nationally recognized statistical rating organization” (“NRSRO”). State and federal laws confer regulatory benefits or prescribe requirements based on credit ratings issued by NRSROs. Before the Act was passed “NRSROs” were “recognised” through the issue of no-action letters by the SEC. The Act replaces this procedure by granting the SEC a statutory authority to oversee the credit rating industry. The express purpose of the Act is:

“ to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.”

The Act seeks to achieve these purposes through the following key features:

- requirements to provide detailed information to the SEC at the time of registration, most of which is made public;
- requirements to update the registration information and to file financial statements;
- requirements to maintain procedures to prevent the misuse of material non-public information and to manage conflicts of interest;
- the prohibition of unfair, coercive or abusive practices.

The information requirements are wide ranging and the SEC will therefore receive a considerable amount of information which it can examine, and it has made extensive record keeping rules so that it can judge whether the policies notified to it are being followed in practice. This information and review process, when combined with the public availability of much of the material provided to the SEC, provides a framework for greater scrutiny and accountability of the NRSROs.

The Act confers on the SEC powers:

- to grant or deny applications for registration and to suspend or revoke registrations. The SEC must deny registration if it finds that the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies that it has disclosed as being used by it (for example procedures to determine credit ratings, manage conflicts, use non-public information);
- to require NRSROs to make public the documents submitted to the SEC (with a few exceptions);
- to take action if the NRSRO issues credit ratings in material contravention of the procedures which it has notified. In particular the SEC may censure, place limitations on the activities, functions, or operations of, suspend for up to 12 months or revoke the registration of any NRSRO which the SEC finds has failed to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.

Information required

The information required as part of or subsequent to registration includes the following.

Credit rating information

- A brief description of how the credit rating agency issues its credit ratings on the internet or through another readily accessible means and information about any fees charged for accessing credit ratings;
- The classes of credit ratings for which it will be registered, the appropriate number of credit ratings issued in each class as of the previous calendar year end and the date on which it first issued credit ratings in that class on a continuous basis.
- Credit rating performance statistics over short-term, mid-term and long term periods (as applicable).
- Definitions of the credit ratings (i.e. an explanation of each category and notch) and explanations of the performance measurement statistics including the metrics used to derive the statistics. The purpose is for the NRSRO to give a general explanation as to how it calculates default and downgrade rates. The SEC considers that this will assist users of credit ratings in understanding how the measurements were derived and in making comparisons with the measurements statistics of other NRSROs.
- A description of the procedures and methodologies used to determine credit ratings (not the disclosure of each actual procedure and methodology). The description has to be sufficiently detailed to provide users of credit ratings with an understanding of the processes which the NRSRO employs to determine credit ratings. These procedures are not submitted as part of the application but SEC requires that they are documented internally by the NRSRO. This means that the procedures and methodologies are available to the SEC staff.

Corporate structure and financial information

- A chart showing the ultimate and sub-holding companies, subsidiaries and material affiliates - to enable the identity of where potential conflicts of interest relating to the business activities of related companies might arise;
- A chart showing the credit rating agencies divisions, departments and business units – to enable an understanding of where potential conflicts relating to ancillary business activities might arise;
- A chart showing the management structure and senior management reporting lines and designated compliance officer reporting lines (to enable the assessment of the relative independence of the compliance officer);
- The total number of credit analysts, the total number of credit analyst supervisors, a general description of the minimum required qualifications of these people, the total aggregate annual compensation paid to credit analysts and the median compensation. The compensation information is not publicly available but is required to be updated.
- A list of the twenty largest issuers and subscribers that use the services by the amount of net revenue received by the agency in the fiscal year immediately preceding the application. This information is not publicly available but must be updated in an unaudited financial report.
- Audited financial statements for the past three fiscal or calendar years. This information is not required to be publicly available. An NRSRO is required to provide audited financial statements annually to the SEC.
- The amount of revenue generated from various credit rating services and a separate computation of total revenue from all other services. The information is not made publicly available and is required to be updated.

Compliance procedures

- Its written policies and procedures to prevent the misuse of material non-public information in violation of the Exchange Act.
- Whether the agency has a code of ethics or an explanation of why it has not established one. A copy of any code must also be provided.
- A list describing in general terms the types of conflicts of interest that arise from its business activities. The registration form lists ten different generic conflicts that may apply. A credit rating agency can provide its own description or further explanations. In addition it must disclose any other material conflict.
- A copy of its written policies and procedures to address and manage conflicts of interest. Whilst these policies will generally be public, there is no public disclosure of specific proprietary information to the public or of information which would diminish the effectiveness of the procedures if it were disclosed.
- The name, address and information about the designated compliance officer. This person is responsible for administering the NRSRO's policies and procedures designed to prevent the misuse of non public information, to manage conflicts of interest, and to ensure compliance with the securities laws.

(In addition to the above new applicants have to provide a certification from at least 10 "qualified institutional buyers" ("QIB") but these are not required to be made publicly available or to be updated after registration. The QIB certifies that it has used the credit ratings of the applicant for at least three years immediately preceding the date of the application, meaning that it has seriously considered the credit ratings of that agency in the course of making some of its investment decisions for at least the preceding three years.)

Updating information; annual certification

NRSROs must promptly update their application if, after registration, any information or document provided as part of the application becomes materially inaccurate. The information on credit ratings performance statistics must only be updated on an annual basis.

On an annual basis the NRSRO must certify that the information and documents provided in the registration application continue to be accurate and list any material change to the information and documents during the previous calendar year.

The NRSRO must provide to the SEC on a confidential basis financial statements and information concerning its financial condition and may be required to provide the SEC on an annual basis four or possibly five financial reports. These include audited financial statements, certain information about the NRSRO's revenues, the total aggregate and median annual compensation of the credit analysts and a list of the twenty largest issuer and subscriber customers in terms of net revenue earned from the customers, and any obligor or underwriter customers that are as large as or larger than the twentieth largest issuer or subscriber customer.

Confidentiality

The NRSRO must make its current registration form and the related information and documents publicly available within 10 business days of being granted an initial registration and within 10 business days of furnishing an update to amend information, or providing the annual certification. Certain information is not required to be made public (examples given above), otherwise an applicant can seek confidential treatment for specific information in the application and the SEC will apply the general laws in this area to the consideration of such an application.

Record keeping requirements

NRSROs are required to make and retain records (generally for three years). The purpose is to assist the SEC in monitoring the NRSRO, for example, enabling it to examine whether the NRSRO is adhering to its credit rating procedures and methodologies.

Record keeping rules include requirements to keep records:

- reflecting entries to and balances in all general ledger accounts for each fiscal year and all records underlying the information included in the annual financial reports;
- of the identity of any credit analysts that participated in the determination of any current credit ratings, the identity of the persons who approved the credit rating before it was issued, whether the credit rating was solicited or unsolicited and the date the credit rating action was taken;
- to show each person (e.g. issuer, underwriter) that has paid for the issuance or maintenance of a credit rating and the credit ratings determined or maintained for the person;
- listing general types of services and products offered by the NRSRO, to enable identification of ancillary business activities and potential conflicts of interest;
- documenting the established procedures and methodologies used to determine credit ratings;
- listing each security and its corresponding credit rating issued by an asset pool or as part of any asset backed or mortgaged backed securities transaction where the NRSRO in determining the credit rating for the security treats assets within such pool or as part of such transaction that are not subject to a credit rating of the NRSRO by one or more of four ways specified in the rule to determine a credit rating for the security. The purpose is to enable monitoring of practices in the structured product area that could be anti-competitive.

NRSROs are required to retain:

- internal records including non-public information and work papers used to form the basis of a credit rating (including notes of conversations with management of issuers);
- credit analysis reports, credit assessment reports, private credit rating reports and internal records used to form the basis for the opinions expressed in these reports. This is to assist in monitoring whether it is complying with its policies for misuse of material non-public information;
- compliance reports and compliance exception reports;
- internal audit plans, internal audit reports, records identified by internal auditors as necessary to perform the audit of credit rating activities;
- copies of marketing materials;
- external and internal communications that relate to initiating, determining, maintaining, changing or withdrawing a credit rating;
- various internal documents where the NRSRO has rated a pool of assets where some of the assets were rated by another NRSRO (to enable monitoring of potential anti-competitive procedures).

Procedures to prevent the misuse of material non-public information

The NRSRO must establish procedures to address three areas where material non-public information could be inappropriately disclosed or used. It is required to establish, maintain and enforce written policies and procedures reasonably designed to prevent such misuse. The SEC rules require procedures reasonably designed to:

- prevent the inappropriate dissemination within and outside the NRSRO of material non-public information obtained for the purpose of developing the credit rating. The rule does not prescribe specific procedures but, for example, NRSROs may have procedures concerning training of credit analysts, defining the persons with whom the credit analyst can share information, re-

- quiring the safeguarding of documents;
- prevent a person within the NRSRO from purchasing, selling or otherwise benefiting from any transaction in securities or money market instruments when the person is aware of material non-public information obtained for the purpose of developing a credit rating;
- prevent the inappropriate dissemination within and outside the NRSRO of a credit rating action before issuing the credit rating on the internet or through another readily accessible means.

Procedures to manage conflicts of interest

The Act requires the SEC to have rules which prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings. Four types of conflict are prohibited outright being:

- conflicts relating to the issuance of a credit rating where the person soliciting the credit rating was the source of 10% or more of the total net revenue of the NRSRO during the most recently ended fiscal year;
- conflicts relating to the issuance of a credit rating with respect to a person where the NRSRO, a credit analyst who participated in determining the credit rating or a person responsible for approving it, directly owns securities of, or has any other direct ownership interest in the rated person;
- conflicts relating to the issuance of a credit rating where the rated entity is a person associated with the NRSRO;
- where the credit analyst who participated or the person responsible for approving the credit rating is also an officer or director of the person that is the subject of the credit rating.

Other conflicts are prohibited unless disclosed and managed. Conflicts procedures are required to manage conflicts which involve:

- being paid by issuers, underwriters or obligors for ancillary services when they also have paid for a credit rating;
- being paid by subscribers for access to credit ratings and for other credit rating services where such subscribers may use the credit ratings to comply with and obtain benefits or relief under statutes and regulations using the term "Nationally Recognised Statistical Rating Organisation";
- being paid by subscribers that may also own investments or have entered into transactions that could be favourably or adversely impacted by a credit rating issued by the NRSRO;
- allowing persons within the NRSRO to own directly securities or money market instruments of, or having any other direct ownership interests in issuers or obligors subject to a credit rating determined by the NRSRO;
- allowing persons within the NRSRO to have a business relationship that is more than an ordinary course business relationship with an issuer or obligor subject to a credit rating determined by the NRSRO;
- having a person associated with the NRSRO that is a broker or dealer engaged in the business of underwriting securities or money market instruments;
- any other type of conflict that is identified on the registration application.

Prohibited unfair, coercive or abusive practices

SEC rules prohibit acts or practices which it determines are unfair, abusive or coercive including:

- conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor of other services or products of the NRSRO or any person associated with it;
- modifying or threatening to modify a credit rating or otherwise departing from systematic procedures and methodologies based on whether the obligor purchases or will purchase the credit rating or any other service or product of the NRSRO;
- lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset backed or mortgage backed securities transaction, unless a portion of the assets within such pool is also rated by the NRSRO;
- where such practice is engaged in by the NRSRO for an anti-competitive purpose.

Appendix II

Mandate to ESME for advice

Role of credit rating agencies

This mandate requests ESME's advice on certain issues concerning the role of credit rating agencies (CRAs) and the importance of ratings in the financial markets, and in particular in the field of structured finance.

Following the recent developments in the field of CRAs (e.g. sub-prime market crisis, new US Act on CRAs) the Commission services would like to request advice from ESME on specific issues related to the regulation of CRAs.

This mandate is to ensure that the Commission has adequate technical background to be able to complete its examination of the rating process following the recent developments in the financial markets.

1. BACKGROUND AND LEGAL FRAMEWORK

CRAs play a vital role in global securities and banking markets. It is essential, therefore, that they consistently provide ratings which are independent, objective and of the highest possible quality.

The European Commission adopted on 23 December 2005 a Communication setting out its approach to CRAs¹. Against the background of various financial scandals in the US and the EU and following the resolution on CRAs adopted by the European Parliament in February 2004, the Commission has considered very carefully whether or not fresh legislative proposals are required to regulate the activities of CRAs. One of the central principles of "Better Regulation" is that legislative solutions should be applied only where there is a market failure and where legislation is strictly necessary to address that market failure and to achieve public policy objectives. In line with advice received from the Committee of European Securities Regulators (CESR) in March 2005, the Commission decided not to present new legislative proposals in the area of CRAs considering that the existing financial services directives applicable to CRAs – combined with self-regulation by the CRAs on the basis of the International Organisation of Securities Commissions (IOSCO) Code – would provide an answer to all the major issues of concern raised by the European Parliament. The Commission stipulated clearly in its Communication that it would monitor the developments in this area very carefully, with the help of CESR which would monitor the implementation of the IOSCO Code by

¹ Communication from the Commission on Credit Rating Agencies COM (2006) OJ 11.3.2006 and the Annex including IOSCO Code of Conduct Fundamentals for Credit Rating Agencies may be found under: http://europa.eu.int/comm/internal_market/securities/agencies/index_en.htm

the CRAs and report to the Commission on a yearly basis. Moreover, the Commission indicated that it might consider introducing new proposals if it became clear that compliance with EU rules or the IOSCO Code was unsatisfactory or if new circumstances were to arise – including serious problems of market failure or fresh developments in other parts of the world. Finally, the Commission noted that there was no clear indication of any anti-competitive practices in this industry but any evidence to the contrary would be examined thoroughly.

Following the recent developments in the field of CRAs (e.g. sub-prime market crisis, new US Act on CRAs) the Commission services would like to request advice from ESME on specific issues related to the regulation of CRAs.

2. CONSULTATION AND SOURCES OF ADVICE

In parallel to this request advice is sought from the Committee of European Securities Regulators (CESR). A copy of our letter to CESR for advice has been made available on CESR's website.

ESME should also note that the US Congress, Securities and Exchange Commission (SEC) and IOSCO (in cooperation with Committee on the Global Financial System) are looking into the rating business. ESME should be aware of what is being publicly discussed and proposed. The Commission services also recommend that ESME invite practitioners from the rating business (present and former) and users of ratings in preparation of their report.

3. THE PRINCIPLES TO WHICH ESME SHOULD HAVE REGARD

As regards its working approach, ESME is invited to take account of following principles:

- The principles set out in the Decision² establishing ESME;
- ESME should provide comprehensive advice on the matters described below;
- ESME should address to the Commission any questions which arise in the course of its work.

4. QUESTIONS IN RELATION TO WHICH ADVICE IS SOUGHT

General questions

ESME is 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.

² See Decision 2006/288/EC, OJ L 106, 19.4.2006, p. 14,
http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_106/l_10620060419en00140017.pdf

- 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.

Specific questions

ESME is asked to consider the following specific questions and provide practical evidence regarding these issues of concern. ESME is also requested to provide its views for improvement of the rating process in respect of any deficiency identified.

- (1) Does ESME consider that the particular oligopolistic market structure influences competition amongst the CRAs in a way that may have a negative impact on the quality / integrity of the rating process?
- (2) What are ESME's views on the quality of ratings and does ESME consider that rating methodologies are sufficiently robust, in particular for structured finance ratings? Does ESME consider that CRAs staff's understanding of the rapidly and growing complex structured finance market is satisfactory?
- (3) Does ESME consider the rating methods, including the assumptions within these methodologies, sufficiently transparent?
- (4) Have CRAs made sufficiently clear how the meaning of structured finance ratings differs from corporate ratings. If not, would it be desirable that CRAs make a clear distinction in terms of rating "labels" between corporate and structured finance ratings?
- (5) Does ESME consider that the level of transparency regarding rating changes should be improved? In particular, are the reasons for rating changes sufficiently clear?
- (6) As regards the timeliness of rating changes, does ESME consider that CRAs have adequate resources for ongoing surveillance of existing ratings? Does ESME consider that CRAs need to improve the timeliness of rating decisions and, is the cycle of review appropriate and adequate for structured finance in view of the particular market dynamics?
- (7) Does ESME believe that rating analysts should be required to obtain a formal qualification in credit rating according to agreed standards before practicing as such?
- (8) Does ESME believe that the rating agencies respond adequately to the increased risks of future default arising from changed market circumstances which reflect in current delinquencies and foreclosures?
- (9) Does ESME believe it is appropriate that a rating agency is not obliged to verify information via due diligence or to conduct an investigation or review to establish the integrity of core information used in the rating process?
- (10) Should rating agencies put in place more automated and objective systems, based for example on the changing value of underlying assets / cashflows, to facilitate more dynamic rating?

- (11) Should rating analysts be required to serve "cooling off" period before working for a client (i.e. "gardening" leave)?
- (12) How does ESME believe that risks of conflicts of interest arising in the interaction between issuers/arrangers and CRAs might be more effectively mitigated? In particular, for example, does ESME believe that the independence of the rating assessment process should be underpinned by having a separate and direct reporting line to a committee of independent directors on the rating agency boards?
- (13) Are there any other issues related to the role of CRAs ESME would like to raise?

5. DUE DATE

ESME's advice is sought by 31st May 2008.

Appendix III - ESME membership

The members of ESME do not represent their respective firms but participate on an individual basis to contribute their expertise and understanding of financial markets to help the Commission understand the potential impact of such issues and the options available to respond to them. ECB and CESR representatives are observers at the meetings of the ESME (Sub-) Group.

Sebastián Albella Amigo - Linklaters

Chris Bates - Clifford Chance**

Mats Beckman - Lindahl

Margaret Chamberlain - Travers Smith*

Carmine DiNoia - Assonime

Philippa Dodd - Royal Dutch Shell*

Gianluca Garbi – Dresdner Kleinwort*

Wolfgang Gerhardt - Bank Sal. Oppenheim jr. & Cie.

John Holland - UBS Investment Bank*

Karl-Peter Horstmann - RWE Trading

Henny Kapteijn – Delta Lloyd*

David Meagher*

Roger Müller - Deutsche Börse

Bertrand Patillet - Crédit Agricole Cheuvreux

Els Ponnet - Fortis Bank

Andrew Procter - Deutsche Bank

Xavier Rolet - Lehman Brothers International Europe

María Gracia Rubio de Casas - Baker & McKenzie

Florence Sirel - BNP Paribas*

Tomasz Stachurski - ING Bank Slaski

*Participants in ESME sub group on Credit Rating Agencies

**Abstained from conclusions of this report.

Bibliography

FT, *Lex Column: As simple as ABX*, 6 December 2007

<http://search.ft.com/ftArticle?queryText=as+simple+as+abx&y=7&aje=true&x=19&id=071206000229&ct=0>

BIS, *Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, June 2004, Annex II

<http://www.bis.org/publ/bcbs107.htm>

AMF, *AMF 2007 Report on rating agencies: Credit Rating of Corporate Issuers*, 17 January 2008

CDO boom masks subprime losses, abetted by S&P, Moody's Fitch, Bloomberg, 31 May 2007

http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajs7BqG4_X8I#

FT: *Reclaim power from the ratings agencies*, 24 August 2007

<http://search.ft.com/ftArticle?queryText=calomiris&aje=true&id=070824000648&ct=0>

CEBS, *Guidelines on the recognition of External Credit Assessment Institutions*, 20 January 2006

<http://www.c-eps.org/pdfs/GL07.pdf>

Official Journal of the European Union, *Communication from the Commission on Credit Rating Agencies*, 11 March 2006, C59/2, Item 3.1

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:059:0002:0006:EN:PDF>

CESR, *Technical advice to the European Commission on possible measures concerning credit rating agencies*,

30 March 2005 http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=3157

IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies*, December 2004

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>

IOSCO, *Consultation Report: The Role of the Credit Rating Agencies in Structured Finance Markets*, March 2008

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf>

Testimony of Michael Kanef (Moody's) before the US Senate Committee on Banking, Housing and Urban Affairs, 26 September 2007

<http://banking.senate.gov/files/kanef.pdf>

The Fundamentals of Structured Finance Ratings, S&P, 23 August 2007

http://www2.standardandpoors.com/spf/pdf/fixedincome/Fundamentals_SF_Ratings.pdf

Statement of Lawrence J White for the Committee on Banking, Housing, and Urban Affairs, US Senate, 26 September 2007

<http://banking.senate.gov/files/ACF75BA.pdf>

US Treasury, *A Hearing of the Senate Banking, Housing and Urban Affairs Committee*, 26 September 2007

<http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=279>

Brian Clarkson, President of Moody's, quoted in *The Economist*, February 7th 2008

http://www.economist.com/finance/displaystory.cfm?story_id=10655009&CFID=12442145&CFTOKEN=34d70193dcfd5ea-1D0BFD1E-B27C-BB00-01270ACEA195F00F

Testimony of Professor John C. Coffee, Jr. before the Senate Banking Committee, 26 September 2007

<http://banking.senate.gov/files/ACF75B1.pdf>

CESR, *The role of credit rating agencies in structured finance*, February 2008

http://www.cesr-eu.org/index.php?page=home_details&id=267

Testimony of Vickie A Tillman (S&P) before the US Senate Committee on Banking, Housing and Urban Affairs, 26 September 2007

<http://banking.senate.gov/files/ACF75B8.pdf>

BIS, *CDO rating methodology: Some thoughts on model risk and its implications*, BIS Working Papers, No.163, November 2004

<http://www.bis.org/publ/work163.pdf?noframes=1>

Henry Maxey, *Cracking the Credit Market Code*, Ruffer LLP

Should Moody's Consider Differentiating Structured Finance and Corporate Ratings?, Request for Comment, Moody's, February 2008

http://www.moodys.com/moodys/cust/research/MDCdocs/04/2007000000473268.pdf?doc_id=2007000000473268&frameOfRef=corporate

Bank of England, *Financial Stability Report*, October 2007, Issue No.22

<http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0710.pdf>