

# **CONSULTATION REPORT**

## **THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS**



**TECHNICAL COMMITTEE  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**MARCH 2008**

**This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.**

## Foreword

IOSCO is pleased to publish the consultation paper prepared by the Technical Committee in relation to credit rating agencies. The paper has two objectives. Firstly, to provide analysis of the role of credit rating agencies in structured finance markets. Secondly, to propose several recommendations for modifying the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. Attached hereto as Annex A, is a version of the current IOSCO Code of Conduct Fundamentals for Credit Rating Agencies marked to show the proposed recommended modifications.

The paper is published for information and comment. Comments as to whether the paper correctly analyzes the role of credit rating agencies in structured finance markets and as to the proposed recommendations for modifying the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies would be welcomed.

## How to Submit Comments

Comments may be submitted by one of three methods **on or before 25 April 2008**. To help us process and review your comments more efficiently, please use only one method.

### 1. E-mail

- Send comments to Ms. Kim Allen: [k.allen@iosco.org](mailto:k.allen@iosco.org).
- **The subject line of your message should indicate “Comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies.”**
- Please do not submit attachments as HTML, GIF, TIFF, PIF, or EXE files.

**OR**

### 2. Fax

Send a fax to the attention of Ms. Kim Allen, using the following fax number:  
34 (91) 555 93 68.

**OR**

### 3. Mail

Send your comment letter to:

Ms. Kim Allen  
IOSCO General Secretariat  
C/ Oquendo 12  
28006 Madrid  
Spain

- **Your letter should indicate prominently that it is a public comment on the “IOSCO Technical Committee Consultation Report on Credit Rating Agencies.”**

**Important:** All comments will be made publicly available, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO-website. Personal identifying information will not be edited from submissions.

## BACKGROUND TO THE TASK FORCE WORK

In 2003, the Technical Committee of the International Organization of Securities Commissions formed a task force of its members' principal representatives to study issues related to the activities of credit rating agencies (CRAs). This Chairmen's Task Force on Credit Rating Agencies (frequently referred to as the CRA Task Force) issued a report in September 2003 describing the role CRAs play in the global capital market and issues that CRAs currently face that may have an impact on the quality of the credit ratings they publish.<sup>1</sup> At the same time that the Technical Committee published this report, it also published a set of principles that regulators, CRAs and other market participants might follow as a way to better guard the integrity of the rating process and help ensure that investors are provided with ratings that are timely and of high quality.<sup>2</sup>

The IOSCO CRA Principles are high-level and meant to be used by CRAs of all types and sizes, using all types of methodologies, and operating under a wide variety of legal and market environments. Shortly after their release, several CRAs advised IOSCO's Technical Committee that it would be helpful to them and other market participants if the Technical Committee were to describe in more detail how the IOSCO CRA Principles might be applied in practice. Subsequently, the CRA Task Force drafted the Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code of Conduct)<sup>3</sup> designed to serve as a model upon which CRAs could base their own codes of conduct as a way of implementing the IOSCO CRA Principles. Like the IOSCO CRA Principles, the IOSCO CRA Code of Conduct was designed for CRAs of all sizes and business models operating around the world. The IOSCO CRA Code of Conduct contains more than 50 different provisions that IOSCO's Technical Committee believes should govern the activities of CRAs to help them guard against conflicts of interest, ensure that their rating methodologies are used consistently by their employees, provide investors with sufficient information that they can judge the quality of a CRA's ratings, and generally help ensure the integrity of the rating process.

In February 2007, the Technical Committee published as a consultation document a "Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies" which noted, among other things, that most major CRAs had adopted codes of conduct based on the IOSCO CRA Code of Conduct, but that implementation varied among smaller CRAs.<sup>4</sup> The Implementation Report concluded that for the most part, the IOSCO CRA Code of Conduct was

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<sup>1</sup> *Report on the Activities of Credit Rating Agencies* (IOSCO Technical Committee, September 2003, accessible via the Internet at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf>) (CRA Report).

<sup>2</sup> *IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies* (IOSCO Technical Committee, September 2003, accessible via the Internet at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf>) (IOSCO CRA Principles).

<sup>3</sup> *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO Technical Committee, December 2004, accessible via the Internet at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>).

<sup>4</sup> *Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies* (IOSCO Technical Committee, accessible via the Internet at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD233.pdf>) (Implementation Report).

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accomplishing the stated objectives but that IOSCO should do more to publicize the IOSCO CRA Code of Conduct and that some aspects of the IOSCO CRA Code of Conduct could be improved through clarification. Comments IOSCO received from CRAs, issuers, investor groups and other market participants generally supported the Technical Committee's conclusions.

In the first quarter of 2007, however, observations relating to the market for residential mortgage-backed securities (RMBSs) and collateralized debt obligations (CDOs) collateralized by or referencing RMBSs raised questions about the quality of CRA ratings and the independence of the CRAs rating RMBSs and CDOs. In particular, as the number of delinquencies on subprime mortgages in the United States suddenly increased, some investors began to question the accuracy of many CDO and RMBS ratings, fueling a growing reluctance to invest in these products by increasingly risk averse investors. As explained in more detail by the work of the Technical Committee's Task Force on Recent Market Events (Subprime Task Force), these questions about the quality of CRA ratings and the integrity of the rating process arguably added to the liquidity crisis that occurred on many markets beginning in August 2007.

As a result of early questions about the quality and independence of structured finance ratings, in April 2007 the Technical Committee reformed the CRA Task Force and asked it to analyze the role CRAs play in the structured finance market and make recommendations if the CRA Task Force concludes that the IOSCO CRA Code of Conduct should be modified to better address issues relating to CRA activities in this area. In conducting its analysis, the CRA Task Force has worked closely with the Subprime Task Force, and the CRA Task Force's conclusions support and are incorporated into the work of the Subprime Task Force.

## **RESPONSIBILITIES AND INCENTIVES**

As described in more detail below, CRAs and their ratings played a critical role in the recent market turmoil. Unlike securities trading on deeper, more transparent markets, credit ratings have had an inordinate impact on the valuation and liquidity of subprime RMBSs and RMBS-backed CDOs. In part, this resulted because many investors and market participants effectively outsourced their own valuations and risk analyses of RMBSs and RMBS-backed CDOs to the CRAs – a tendency the CRAs, some believe, had little incentive to discourage given the growth and profitability CRAs have experienced in this market segment over the past several years. Making matters worse, there are serious questions whether these credit ratings were based on incorrect information and faulty or dated models. While CRAs are not auditors, there are also serious questions whether the CRAs should have reassessed the quality of their methodologies and underlying assumptions when rating subprime structured finance instruments in light of credible information regarding housing market bubbles in the United States, the lack of incentives for mortgage lenders to conduct proper due diligence, and a possible increase in mortgage fraud, among other things.

It is also clear that responsibility for the market turmoil – and, indeed, responsibility for the failures that directly relate to credit ratings – extend far beyond the CRAs. In particular, there are serious questions whether institutional investors, either through ignorance or lax internal governance and risk management, relied excessively on credit ratings, with little regard for the

underlying risks of the financial instruments they bought, sold, and in some cases even designed. Likewise, there are serious questions whether originators also share considerable responsibility for the turmoil, since they employed progressively lax underwriting standards and may have provided the CRAs with inaccurate or misleading information during the rating process, had few incentives to confirm the validity of this information, and, in some cases, may have “ratings shopped” among CRAs to ensure a desired rating regardless of the risks underlying a given instrument. Finally, regulators may need to revisit policies that equate low default risk with low volatility and liquidity risk and thus encourage some market participants to rely entirely on credit ratings in place of these market participants conducting a thorough and separate risk assessment themselves.

This Report will focus primarily on matters relating to the IOSCO CRA Code of Conduct, while issues relating to investors, originators, regulators and other groups will be addressed in more detail in the forthcoming report by the Subprime Task Force.

## **THE ROLE OF CRAS**

Credit rating agencies play an important role in most modern capital markets. The IOSCO Report on the Activities of Credit Rating Agencies notes that CRAs assess the credit risk of corporate and government borrowers and issuers of fixed-income securities by analyzing relevant information available regarding the issuer or borrower, its market, and its economic circumstances.<sup>5</sup> The information processed by the CRA, while generally available to the public, may be costly and time-consuming to collect and analyze. Some CRAs also may obtain non-public information from borrowers and issuers as part of the rating process. The conclusion derived from this analysis is reflected in a credit rating. This rating represents an opinion as to the likelihood that the borrower or issuer will meet its contractual, financial obligations as they become due and is not a recommendation to buy or sell a security. It also does not address market liquidity or volatility risk.

### *CRA ratings of corporate issuers*

Corporations use a variety of methods to raise capital, ranging from short-term commercial paper and standard bank loans to publicly traded equity securities. Where a company issues fixed income securities to be traded on a public market, the issuer may ask a CRA to provide a credit rating for those securities to make them more marketable. In many cases, potential investors may expect an issuer or security to be covered by several CRAs. Investors also may operate under guidelines or legal requirements that prohibit the investor from holding a debt security that is not rated at or above a certain level by one or more CRAs. An issuer that chooses to have its debt securities rated will contract with a CRA for the issuance and maintenance of a credit rating. In some cases, a CRA will undertake to rate an issuer without first being requested by the issuer to do so (frequently referred to as an “unsolicited” rating).

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<sup>5</sup> CRA Report, p. 1.

As described in more detail in the CRA Report,<sup>6</sup> the processes used by CRAs vary widely, depending on the CRA itself and the methodologies used. However, at the center of the rating process for the larger CRAs typically is a rating committee composed of a lead analyst, managing directors or supervisors, and junior analytical staff. Rating committees are formed to initiate, revise or monitor a rating, and rating decisions are made by simple majority votes of these committees. At the start of the rating process, the CRA will assign a lead analyst. The analyst gathers information from the issuer (in some cases non-public information) and researches other available sources for information to provide the analyst with a better understanding of the issuer, including its financial condition, and its industry/economic environment. Using this information and the CRA's rating methodology, the analyst prepares a draft report and recommendation with respect to proposed credit ratings for the issuer's debt securities. This report is submitted to the rating committee, which then approves a final credit rating. Once the rating is published, many CRAs will continue to monitor the issuer and meet with senior management on a periodic basis in order to review whether the current ratings for the issuer and its securities should be maintained or adjusted. The frequency with which a rating is updated varies according to the CRA, the type of issuer, and the security being rated.<sup>7</sup>

While some observers and market participants believe that a CRA rating represents a judgment on the worthiness of an investment (a perception perhaps aggravated by the use of the colloquial term "investment grade" to refer to certain ratings), the opinions of CRAs relate solely to the likelihood that a given debt security will perform according to its terms. As described in previous IOSCO reports, a high credit rating does not necessarily indicate that a security is a good investment, nor does a low credit rating necessarily make the security a poor investment.<sup>8</sup> It is also important to note that CRAs traditionally do not confirm the accuracy of much of the information provided to them by issuers, who maintain ultimate responsibility for the accuracy of the information they provide to the market. Instead, CRAs typically rely on regulators and the independent auditors hired by the issuers for such verification.

### *Rating structured finance products*

Some issuers use structured finance products as a way to raise more capital at a better price than might be possible through other mechanisms. By issuing different securities with different underlying assets serving as collateral, different rights and privileges, or subordinated differently, an issuer may be able to borrow more cheaply (and receive a higher credit rating for a specific

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<sup>6</sup> Id. at 4-5.

<sup>7</sup> Provision 1.9 of the IOSCO CRA Code of Conduct states:

*Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating by:*

- a. regularly reviewing the issuer's creditworthiness;*
- b. initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology; and,*
- c. updating on a timely basis the rating, as appropriate, based on the results of such review.*

<sup>8</sup> See, e.g., IOSCO CRA Code of Conduct at 3.

security) for a specific purpose than it might be able to by issuing a traditional “plain vanilla” corporate bond.

As originally envisaged, however, rather than being designed to raise capital for an issuer (typically a corporation of any type), some structured finance products such as RMBSs were designed primarily to diversify the risk held on the balance sheet of an issuer (which is often, but not necessarily, a financial institution). This risk is often held in the form of long-term loans or other debt instruments, and rather than offering investors a share in the cash-flow of the issuer as an enterprise, the issuer offers investors a share in the cash-flow of the enterprise’s own assets, taking advantage of the differing risk preferences and investment time horizons of different investors. As with corporate issuers of structured financial products, in order to do this, the assets being securitized must be segregated according to the risk they present. Issuers do this by dividing the assets being securitized into “tranches,” grouping similar loans, debt instruments or other assets with similar underlying risks.

In its simplest form, each tranche is then securitized and the resulting product may be rated by a CRA. Because structured financial products are designed to take advantage of different investor risk preferences and investment time horizons, they are, in a sense, designed for a particular credit “rating” (even in cases where no CRA opinion or formal credit rating is sought). Where credit ratings are sought, the “rating process” for these products can appear to be the reverse of how a more traditional product is rated. This is because the issuer of the structured product often decides beforehand what rating it would like for each tranche (presumably within the limits of what is possible), and the tranches are structured accordingly. Some critics have argued that the inherently iterative nature of this process may give rise to potential conflicts of interest.

More recently, however, some structured finance debt securities such as RMBSs and CDOs have been designed to be a funding mechanism used by financial institutions to package and sell assets that they either originate or purchase from an originator or other source. In some markets, rather than principally diversifying risk away from a financial institution, this “originate-to-distribute” (OTD) business model primarily aims to earn fees from distributing a steady flow of re-packaged assets rather than from holding a static portfolio of assets on the balance sheet.<sup>9</sup> In basic terms, the business model is executed by the financial institution by first accumulating a pool of assets such as residential mortgages, RMBS, or commercial loans. The firm then creates a bankruptcy remote trust that will purchase the asset pool and issue debt securities to ultimately finance the transaction. The trust receives interest and principal payments from the asset pool and uses those funds to make interest and principal payments on the trust securities. CRAs frequently are contracted to issue and maintain credit ratings on the trust securities.

CRAs first issued ratings for mortgage-backed securities in the mid-1970s. In subsequent years, they began rating other types of asset-backed securities, including those collateralized by credit card receivables, auto loans, student loans, and equipment leases. They started rating cash CDOs

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<sup>9</sup> Some critics have argued that the proliferation of the OTD model may have weakened the incentive of originators to assess and monitor the risks attached to the underlying assets. Some critics also question the extent to which CRAs took into account this possibly distorted incentive structure. Others, however, argue that there is no clear evidence that CRAs did not take into account all inherent, related incentive risks, or that possible price distortions and problematic incentives are unique to the OTD model.



in the late 1990s and synthetic CDOs in the early 2000s. Not all structured finance products are rated by CRAs. Indeed, for many particularly complicated or risky CDOs, credit ratings are unusual. Further, some issuers create structured products specifically for a particular investor that does not require a credit rating because it relies solely on internal analytics to assess the credit risk of the security. As with corporate debt securities, many investors require that a structured finance debt security be rated by a CRA before they will purchase it.

CRAs employ varying methodologies to rate structured finance debt securities but generally they focus on the type of collateral underlying the security (e.g., mortgages, RMBSs, commercial real estate loans, credit card receivables, corporate loans) and the proposed capital structure of the issuer trust. As discussed below, the ratings process involves obtaining information about the collateral pool and proposed structure from the sponsor that will create the trust that issues the securities. This differs somewhat from the rating process for corporate issuers in that much of the information the CRA relies on is included in public filings or other investor disclosures.

While the types of collateral pools and capital structures vary widely across all structured products, the following describes the process of rating a typical RMBS. As noted above, the sponsor of an RMBS will transfer a pool of mortgage loans to a bankruptcy remote trust that will issue securities collateralized by the pool. The trust receives interest and principal payments from the collateral pool and uses those funds to make interest and principal payments due on the trust securities. Further, the trust issues securities in several different classes, known as tranches, based on subordination. For example, if a trust issued securities in 10 different tranches, the first (or senior) tranche would have nine subordinate tranches, the next highest tranche would have eight subordinate tranches and so on down the capital structure. The lowest tranche – while not having a subordinate tranche – might have a level of trust equity below it. The trust equity generally consists of the amount that the collateral pool over-collateralizes the obligations of the trust on the trust securities as well as the accumulation of principal and interest payments by the trust that are not needed to pay interest and principal due on the trust securities (excess spread).

Pursuant to the subordination structure, the various tranches are paid principal and interest by the trust from the funds received from the collateral pool in order of seniority. Thus, any shortfall would be allocated first to the lowest tranche and then to the next lowest tranche and so on up the capital structure. The same is true for any losses realized by the trust as a result of defaults on the trust collateral. The amount of subordinate tranches and trust equity below a given tranche serves as its primary form of “credit enhancement.” Credit enhancement can be further increased through other mechanisms such as bond insurance, pool insurance, and derivatives transactions.

A sponsor typically initiates the RMBS rating process by sending a CRA data on a pool of loans (e.g., principal amount, geographic location, borrower’s credit history, loan-to-value ratio, and type of loan: first lien, second lien, primary residence, secondary residence) and the proposed capital structure of the trust. The CRA assigns a lead analyst who will be responsible for analyzing the loan pool and proposed capital structure of the trust and formulating ratings recommendations for a rating committee. The analyst first develops predictions based on models and other factors as to how many of the loans in the collateral pool would be expected to default under stresses of varying severity. This analysis also includes assumptions as to how much principal would be recovered after a defaulted loan is foreclosed.

The purpose of this loss analysis is to determine how much credit enhancement a given tranche security would need to get a particular credit rating. For example, the severest stress is run to determine the credit enhancement required for a AAA rating. This test might result in an output that predicted that under the “worst case” scenario, 40 percent of the assets in the collateral pool would default and that after default the trust would only recover 50 percent of the principal amount of each loan in foreclosure. Consequently, to get a AAA rating, a trust security collateralized by the pool would need a credit enhancement level of at least 20 percent (40% of loans default x 50% recovery at default). Put another way, the tranches below AAA would need to be sized such that they could incur a 20 percent loss in the aggregate principal of the collateral pool before any loss would be allocated to the AAA tranche. The next severest scenario is run to determine the amount of credit enhancement required of the AA tranche and so on down the capital structure. The lowest tranche (typically BB or B) is analyzed under a benign market scenario. Consequently, its required level of credit enhancement – the trust equity – is the amount of loss expected absent any macroeconomic stress. Some CRAs have the analyst bring the credit enhancement requirements to a “loss committee” that will approve the assumptions before the analyst continues with further ratings analysis.

After determining the level of credit enhancement required for each credit rating category, the analyst will check the proposed capital structure of the RMBSs against these requirements. For example, if the senior level required 20 percent credit enhancement to receive a AAA rating but only would have 18 percent under the proposed structure, the analyst will let the sponsor know that the senior class would only receive a AA rating. The sponsor then could accept that determination and have the trust issue the securities with the proposed capital structure or the sponsor could adjust the structure to provide the requisite credit enhancement for the senior tranche to get the AAA rating (e.g., shift 2 percent of the principal amount of the senior tranche to a lower tranche). Alternatively, the sponsor could choose to not hire the CRA and instead have another CRA rate the security, in which case the sponsor may or may not (depending on the engagement contract) pay the initial CRA a “break-up fee”.

After the structure is settled on by the sponsor, the analyst will perform a cash flow analysis on the interest and principal expected to be received by the trust from the collateral pool to determine whether it will be sufficient to pay the interest and principal due on each tranche of the trust. The analyst also will review the legal documentation for the transaction to verify, among other things, that the subordination structure of the trust as documented is consistent with the structure as proposed by the sponsor. If the cash flow is sufficient and the legal documentation in order, the analyst develops a recommendation for a final credit rating for each tranche. The analyst then brings these recommendations to a ratings committee that either approves them or adjusts them.<sup>10</sup> The CRA then notifies the sponsor of the final ratings decisions. The sponsor then decides whether or not to have the credit rating issued and made public. The CRA typically

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<sup>10</sup> Not all CRAs use rating committees. While the larger CRAs use rating committees when assigning credit ratings, some critics argue that these committees do not necessarily ensure the quality of credit ratings and that their composition, expertise and the procedures they follow may vary considerably from CRA to CRA and even within CRAs, from market to market. Some critics also argue that CRAs that use rating committees should document the discussions of these committees for either regulatory or public review.

only is paid if the credit rating is issued, though sometimes the CRA receives a breakup fee if the credit rating is not issued.

As with corporate ratings, after a CRA issues an initial rating for a RMBS, it generally will continue to monitor the rating. With corporate ratings, this continued monitoring can be important because factors influencing an issuer's chances of default (e.g., economic circumstances, success of product lines, etc.) can change; with RMBSs, these changing factors may include changes to the composition of the security itself (e.g., some mortgages may be removed from the security and replaced by others if they are paid off early). Some CRAs use separate surveillance teams with different analysts and committee members than those who provided the initial rating, in order to provide a new perspective and avoid possible issues that may arise as a result of the original committee members feeling obligated to stand by their original estimations.

### **Reliance on CRA Ratings**

In practice, many structured finance transactions are more complex than the simple structure outlined above. In order to better tailor the risk profile of the resulting securities, tranches may be combined with swaps or other financial devices. Because these securities are predicated on complex legal structures (to place them ahead of or behind other potential creditors), involve complex financial devices (such as swaps or derivatives), and/or comprise possibly thousands of individual underlying assets about which very little public information is available (such as retail mortgages), structured financial products are often viewed as less transparent and far more complicated than corporate debt instruments. Furthermore, because these products usually are only bought and sold by institutional investors, many jurisdictions require less investor disclosure than might be required for publicly traded securities.

However, this popular view that structured finance products are inordinately complex vis-à-vis "traditional" bonds is not entirely accurate, at least from a ratings perspective. Even the most complex synthetic CDOs and other structured finance products theoretically involve underlying cash-flow projections which can be quantitatively modeled. By contrast, ratings of corporate bond issuers frequently involve difficult-to-quantify factors such as market competition, the success or failure of new products and markets, and managerial competence. On the other hand, because so little information about structured finance products is publicly available, "unsolicited" ratings of most CDOs are very rare, and even a CRA that is provided information to form a prospective assessment is unlikely to issue a public rating of the product if it is not hired by the investment bank since the final composition of the tranches may vary by the time the security is issued. While sophisticated institutional investors often have the capability to analyze the risk comprising the tranches of a CDO, doing so can be time consuming even where risk modeling is almost entirely automated.

A credit rating, then, is occasionally viewed as not only a CRA's opinion of the loss characteristics of the security, but also as a seal of approval. This perception is not entirely without merit given that a CRA rating of a structured financial product is qualitatively different from a corporate bond rating based on an issuer's past financial statements because, in a structured finance transaction, the CRA provides the investment bank with input into how a

given rating can be achieved (i.e., through credit enhancements). However, this perception raises regulatory concerns because CRAs do not generally confirm the validity of the underlying data provided to them. Indeed, some CRAs use quantitative models that rely entirely on publicly available information or quantitative information provided by the originator or even a third party. Nonetheless, certain members of the Task Force believe that in some cases some CRAs relied on information that, on its face, appeared questionable or, in the broader context of rapid market changes, uncertain or of dubious quality. Although CRAs cannot be expected to uncover issuer fraud or conduct the level of confirmation expected of independent auditors, ratings based on information that fails to pass even a basic “sniff test,” – or, more importantly, methodologies which fail to take into consideration market changes which may have an impact on the quality of the information upon which the ratings are based – fundamentally undermine investor confidence in the rating process. Consequently, investors and regulators expect CRAs to take reasonable steps to ensure that the information they use is of sufficient quality to support a credible rating.

With respect to structured products, particularly CDOs collateralized by RMBS, investors appear to have relied heavily or solely on the credit ratings of the CRAs. This may be due to several factors including the quantitative challenge of analyzing correlation risk within a portfolio of loans – which difficulty is compounded when considering a CDO composed of a portfolio of RMBSs each composed of a portfolio of loans. In addition, the secondary market for these securities was relatively inactive. Further, there was limited historical performance data on some of the types of loans underlying the RMBS (e.g., second lien loans). Thus, the investor and CRA models used to predict future performance relied on relatively thin data sets. Finally, because many structured finance products are relatively new, there appears to be no universally understood valuation method and price discovery mechanism in the secondary market, as there is in more mature markets. Consequently, in some cases credit ratings appear to have taken on greater import for institutional investors than they might in most other debt markets.

Notably, many financial regulators and the statutes in some jurisdictions also rely on CRA ratings for regulatory or other purposes, and certain CRAs can be considered External Credit Assessment Institutions (ECAIs) under the provisions of the Basel II Accord. In many cases, this entails regulators permitting regulated entities to rely on the ratings of a security in place of the entity assessing the underlying risks of the security itself.

All of these factors may have contributed in some fashion to a situation where some investors inappropriately relied on CRA credit ratings as their sole method of assessing the risk of holding these securities. Consequently, when the quality of the CRAs’ ratings became questioned due to the inordinate number of RMBS and CDO downgrades, some investors were left with no independent means of assessing the risk of these securities. This in turn caused the market for the securities to dislocate.

## **ONGOING REGULATORY ISSUES**

The role CRAs play in structured financial transactions raises a number of possible regulatory issues, some of which touch on sections of the IOSCO CRA Code of Conduct. Among these are:

1. CRA transparency and market perceptions;

2. Independence and avoidance of conflicts of interest; and
3. CRA competition and the interaction this competition may have on CRA independence.

### **Transparency and Market Perceptions**

Partly as a result of the IOSCO CRA Code of Conduct, the larger CRAs publish considerable information about their rating methodologies. These rating methodologies are transparent enough that financial institutions frequently involved in designing structured finance transactions can usually anticipate the level of credit enhancement necessary at each tranche to obtain a desired credit rating.

Nonetheless, while the methodologies may be transparent to those investors with the analytical capability to understand and evaluate them, some market observers suggest that many CRAs do not publish verifiable and easily comparable historical performance data regarding their ratings. While the IOSCO CRA Code of Conduct encourages CRAs to publish historical performance data, there are complaints that this data is not readily comparable. CRAs argue that coming up with a common metric to evaluate the performance of their ratings is not practical or desirable given the differing methodologies they employ. They state that a common metric would push them towards a common methodology, which would deprive the marketplace of the varying approaches employed today. Nonetheless, if the publication of ratings performance data is to have any meaningful use, the CRAs should endeavor to make it transparent and capable of some level of comparison.

A second concern is the failure by some investors to recognize the limitations on CRA rating methodologies for structured finance securities. These methodologies rely on models, which, like most financial analytical tools, assume a certain degree of inductive continuity between the past and the future or between assets that are similar to each other. While past performance is no guarantee of future performance, for tractability purposes the statistical and probabilistic modeling of reference pools have to make use of “homogeneity assumptions” in which it is assumed that the behavior of variables of interest will not change in a disruptive fashion. However, economic and financial environments change. The financial history of the past several decades demonstrates that a confluence of events and practices that has never happened before can nonetheless occur even if the detection of singularities (breaks in time series) is delicate. Arguably, this has happened recently with the subprime market turmoil and there have been suggestions that CRAs have been slow to modify either their methodologies or the assumptions used by their methodologies despite rapid market changes. There have also been suggestions that some CRAs do not adequately disclose the assumptions they used when rating these structured finance products.

A further concern is that some investors may take too much comfort in CRA historical performance statistics for structured finance securities. For example, statistics regarding long-term default rates do not necessarily provide information about short-term default probabilities. The same data might indicate a steady default probability over time, or a very low trend punctuated by occasional default “hiccups.”

The subprime market turmoil has also highlighted another common misperception that credit risk is the same as liquidity risk. Historically, securities receiving the highest credit ratings (for example, AAA or Aaa) were also very liquid – regardless of market events, there could almost always be found a buyer and a seller for such securities, even if not necessarily at the most favorable prices. Likewise, prices for the most highly rated securities historically have not been very volatile when compared with lower-rated securities. Indeed, in some jurisdictions regulations regarding capital adequacy requirements for financial firms implicitly assume that debt securities with high credit ratings are both very liquid and experience low volatility. However, the links between low default rates, low volatility and high liquidity are not logical necessities. Particularly with respect to certain highly-rated, though thinly-traded subprime RMBSs and CDOs, a high credit rating has not been indicative of high liquidity and low market volatility.

Given the differences in the amount of historical data available regarding “traditional” debt instruments such as corporate and municipal bonds versus structured finance products, there have been suggestions from some observers that CRAs should consider using a separate system of symbols when opining on the default risk and loss characteristics of a structured product. In theory, separate rating symbols might make it easier for investors to recognize that structured products may be more volatile and less liquid under stress conditions than more traditional debt instruments might be. Separate symbols may also put investors on notice that the structured products being rated may involve the CRA having access to different types of information and using different types of methodologies than they might for a “plain vanilla” corporate bond. Others, however, argue that a separate system of symbols may be confusing to investors and other market participants, since theoretically default risks for structured finance products are not different than they are for other types of debt instruments. Furthermore, a separate set of symbols for structured finance products may give investors the impression that CRAs are, indeed, opining on the volatility and liquidity risks of traditional products when, in fact, they are not.<sup>11</sup> Given the common misperceptions that appear to exist regarding what CRA ratings do, the CRA Task Force recommends that CRAs study the efficacy and desirability of such an approach.

In this connection, a large number of the Technical Committee members are minded to call for CRAs to differentiate the ratings of structured finance products from corporate debt ratings in order to provide investors with an additional signal about possible differences in how those different types of securities may perform under different stress scenarios. Consequently, as part of the consultation process, the Technical Committee seeks public comment on the desirability of using a different set of rating symbols to differentiate structured finance ratings from ratings of corporate debt securities.

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<sup>11</sup> As noted above, some observers believe that the volatility and liquidity issues related to recent CRA downgrades of structured finance products are the result of the inadequacy of widely agreed upon alternative market mechanisms for valuing these products. Consequently, when investors lost confidence in the opinions of CRAs regarding these products, this thinly-traded market experienced volatility and liquidity shocks since other price-discovery mechanisms were immature or non-existent. By contrast, “traditional” bonds trade more widely and more transparently, and with far more developed price discovery mechanisms in place. As a result, a sudden loss of confidence in CRA ratings may not have the same effects on liquidity, in particular, that occurred in the market for structured finance products.

In addition, one of the criticisms of the CRAs with respect to subprime RMBS and CDOs is that they were slow to review and, if necessary, downgrade existing credit ratings. The CRAs respond to such criticism by noting that their ratings are intended to be long-term views and that to avoid “ratings volatility” they need to respond carefully to market developments in order to avoid reacting to events that are momentary anomalies rather than trends. Nonetheless, the potential exists that a CRA may be reluctant to review an initial rating, particularly if the analysts responsible for the rating also are responsible for monitoring it. Accordingly, CRAs should take steps that are designed to ensure that the decision making process for reviewing and potentially downgrading an initial rating of a structured finance security is conducted in an objective manner which could include separating the initial rating function from the monitoring function, or other suitable means. The CRA Task Force notes that a discussion paper drafted by a group of the larger CRAs proposes (among other things) that the participating CRAs will use such separate surveillance teams as a matter of course. The CRA Task Force supports the effort this discussion paper represents and the review by the CRAs of issues related to these recent market events.<sup>12</sup>

By contrast, other critics claim that some CRAs very quickly downgraded certain structured finance products that had only recently been issued by an originator and rated by the CRA. Since some structured finance products are actively managed, the reasons for such rapid downgrades may vary. The CRA Task Force believes rapid downgrades of this sort should be explained by a CRA to avoid harm to its reputation, since a pattern of such rapid downgrades may lead investors to question the quality of its initial ratings of these products. Nonetheless, as indicated in IOSCO CRA Code of Conduct provision 1.9(b), the CRA Task Force believes that a CRA should not hesitate to review a rating if it becomes aware of new information that might reasonably be expected to result in a rating action, according to the applicable methodology.

Finally, some observers have noted that when CRAs make changes to a rating methodology, it is not always clear whether a given rating was given under the new methodology or under the older approach.

## **Independence and Avoidance of Conflicts of Interest**

Many observers cite the conflicts of interest inherent in the credit rating industry as a source of concern. The most common conflict noted is that many of the CRAs receive most of their revenue from the issuers that they rate. The fear is that where a CRA receives revenue from an issuer, the CRA may be inclined to downplay the credit risk the issuer poses in order to retain the issuer’s business. The IOSCO CRA Code of Conduct contains several provisions designed to mitigate and manage this inherent conflict of interest.<sup>13</sup>

A frequent claim in the aftermath of the subprime market turmoil is that this conflict of interest is even more acute where structured finance transactions are being rated, given the volume of deals and corresponding rating business attributable to particular financial institutions. As with

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<sup>12</sup> Discussion Paper about Measures to Enhance the Independence, Quality and Transparency of Credit Ratings.

<sup>13</sup> See IOSCO CRA Code of Conduct provisions 2.1-2.16.

“traditional” ratings, the CRAs that rate these transactions usually receive the bulk of their revenue from the issuer of the securities (or the investment bank underwriting the arrangement). While market sector data for most CRAs is not available, there is evidence to indicate that the growth of the CDO market over the past several years has made structured finance ratings one of the fastest growing income streams for the major CRAs. This creates a risk that the CRAs will be less inclined to use appropriately conservative assumptions in their ratings methodologies in order to maintain transaction flow.

An additional concern is that CRAs are doing more than rating structured finance securities, namely: advising issuers on how to design the trust structures. In the corporate area, CRAs will provide a “private rating” based on a pro forma credit assessment of the impact of a potential transaction (e.g., merger, asset purchase) on the company’s credit rating. In the IOSCO CRA Code of Conduct, a CRA is encouraged to “separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest.”<sup>14</sup> Furthermore:

The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA’s rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.<sup>15</sup>

The serious question that has arisen is whether the current process for rating structured finance involves advice that is, in fact, an ancillary business operation which necessarily presents a conflict of interest. Conversely, while some observers believe that the structured finance rating process does not necessarily pose an inherent conflict of interest vis-à-vis the CRA’s rating business more generally, the further question is whether a CRA has sufficient controls in place to minimize the likelihood that conflicts of interest will arise.

## **Competition**

A final regulatory issue that may have undermined the integrity of the rating process for structured financial transactions is the lack of competition in the CRA industry. While the CRA Report noted in 2003 that CRAs were not extensively regulated in most IOSCO jurisdictions and those regulations that did exist are not onerous for new entrants, since that time, some jurisdictions have introduced new regulations regarding CRAs with, at this point, unknown effects on CRA industry competition. Perhaps more importantly, as the CRA Report notes, some observers believe the nature of the CRA “market” may make it difficult for new CRA entrants to succeed, regardless of any regulatory barriers to entry (or lack thereof). According to this view, issuers desire ratings from only those CRAs respected by investors. On the other hand, investors respect only those CRAs with a reputation for accuracy and timeliness in issuing credit ratings. Establishing such a reputation can take considerable time and resources. Furthermore, some observers have suggested that issuers may prefer to retain, and investors may prefer to use the opinions of, CRAs that a government regulator or agency also uses. Where government CRA

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<sup>14</sup> IOSCO CRA Code of Conduct provision 2.5.

<sup>15</sup> Id.



recognition criteria are based on how extensively a CRA's opinions are used by issuers and investors, such a situation obviously discriminates against new entrants. Moreover, to the extent that regulatory recognition is based on reliance by the market, and market reliance is influenced by regulatory recognition, the cycle of discrimination is perpetual.

Implicit in the discussions about competition and barriers to entry in the CRA industry is the understandable concern that such lack of competition (1) may have a detrimental effect on the development of new CRA methodologies, (2) may result in oligopolistic or monopolistic pricing by the dominant CRAs, and (3) may effect ratings quality by inhibiting innovation. Where "traditional" debt securities are involved, the structure of the CRA industry makes these concerns seem quite credible. Some data indicates that the largest three CRAs (Moody's Investor Services, Standard & Poor's, Inc. and Fitch, Inc.) collectively comprise approximately 85 percent of the CRA market. For most traditional debt securities, investors typically have expected that an issuer provide at least two ratings from the larger CRAs, with anecdotal evidence indicating that some investors now expect three such ratings as "younger" CRAs have become more prominent in the CRA industry.

While problematic for issuers because of the limited degree of competition in the CRA industry, these tacit investor requirements may have several beneficial effects from an investor perspective. By effectively mandating that an issuer seek opinions from a relatively small group of CRAs, these investor requirements make it difficult for an issuer to pressure a CRA into providing a favorable rating or else risk losing its business or losing access to critical issuer information. As discussed in the Technical Committee's Report on Securities Analyst Conflicts of Interest,<sup>16</sup> precisely this type of situation led some securities analysts to avoid downgrading powerful issuers and, in some jurisdictions, led to prohibitions on issuers providing nonpublic information to only favored analysts.<sup>17</sup> Likewise, unsolicited ratings, while controversial, nonetheless are possible and frequently expected of smaller CRAs and may provide a degree of protection against "blackballing" by issuers dissatisfied by a CRA's rating opinions.

As discussed previously, however, structured finance transactions are inherently less transparent and unsolicited ratings for many structured finance products may be difficult. Investment banks and structured finance issuers frequently ask CRAs to provide prospective assessments on CDO tranches before deciding upon which CRA to hire, arguably engaging in "rating shopping" in doing so. It is conceivable therefore, that CRA competition and the lack of transparency typical in structured finance transactions may combine to undermine the integrity of the credit rating process for these products. Supporting this view are news reports that some CRAs very rapidly lost market share in the market for rating commercial mortgage back securities (CMBSs) by requiring more conservative assumptions following instability in the RMBS market.

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<sup>16</sup> *Report on Analyst Conflicts of Interest* (IOSCO Technical Committee, September 2003), p. 10 (accessible via the Internet at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD152.pdf>).

<sup>17</sup> See, e.g., US SEC Final Rule: Selective Disclosure and Insider Trading (Regulation FD) (accessible via the Internet at: <http://www.sec.gov/rules/final/33-7881.htm>).

## **RECOMMENDATIONS**

Given the role CRAs play in rating structured finance transactions as highlighted by recent turmoil in this market sector, the CRA Task Force proposes several recommendations for modifying the IOSCO CRA Code of Conduct. The CRA Task Force notes that the IOSCO CRA Code of Conduct provides a mechanism for a CRA to explain why a particular provision is not being complied with.

### **Quality and Integrity of the Rating Process**

The IOSCO CRA Code of Conduct section 1 should be modified such that:

1. A CRA should take steps that are designed to ensure that the decision-making process for reviewing and potentially downgrading a current rating of a structured finance product is conducted in an objective manner. This could include the use of separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, or other suitable means. If separate teams are used, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner. Subsequent monitoring should incorporate subsequent experience obtained. Changes in ratings criteria and assumptions should be applied where appropriate to subsequent ratings.
2. CRAs should establish an independent function responsible for periodically reviewing both the methodologies-and-models and the changes to the methodologies-and-models used in the rating process.
3. CRAs should adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating. If the rating involves a type of financial product with limited historical data upon which to base a rating, the CRA should make clear, in a prominent place, the limitations of the rating and any risks associated with credit ratings of such products.
4. CRAs should ensure that the CRA employees that make up their rating committees (where used) have appropriate knowledge and experience in developing a rating opinion for the relevant type of credit.
5. CRAs should establish a new products review function made up of one or more senior managers with appropriate experience to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates.
6. CRAs should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to

whether the CRA can determine a credit rating for the security that fits within its established categories of credit ratings, the CRA should refrain from issuing a credit rating.

7. A CRA should prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.
8. CRAs should ensure that adequate resources are allocated to monitoring and updating its ratings.

### **CRA Independence and Avoidance of Conflicts of Interest**

The IOSCO CRA Code of Conduct section 2 should be modified such that:

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

### **CRA Responsibilities to the Investing Public and Issuers**

The IOSCO CRA Code of Conduct section 3 should be modified such that:

13. A CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the limits to which it verifies information provided to it by the issuer or originator of a rated security.
14. In order to discourage "ratings shopping," a CRA should disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating; or (2) contracts with the CRA for a final rating

and does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.

15. A CRA should publish verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.
16. Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.
17. A CRA should disclose whether it uses a separate set of rating symbols for rating structured finance products, and its reasons for doing so or not doing so. In any case, a CRA should clearly define a given rating symbol and apply it in the same manner for all types of products to which that symbol is assigned.
18. A CRA should disclose the principal methodology or methodology version in use in determining a rating.

#### **Disclosure of the Code of Conduct and Communication with Market Participants**

The IOSCO CRA Code of Conduct section 4 should be modified such that:

19. A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.

**Chairmen's Task Force on Credit Rating Agencies**  
**THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS**

Chairman: Mr. Ethiopis Tafara  
U.S. Securities and Exchange Commission

Australian Securities and Investments Commission  
(Australia)

Mr. Mark Adams  
Mr. Malcolm Rodgers

Comissão de Valores Mobiliários (Brazil)

Mr. Carlos Alberto Rebello

Autorité des marchés financiers (France)

Ms. Catherine Dias  
Mr. Xavier Tessier

Bundesanstalt für Finanzdienstleistungsaufsicht  
(Germany)

Mr. Christian Buck  
Mr. Jörg Schmidt-Ebeling  
Mr. Thomas Schmitz-Lippert  
Mr. Philipp Sudeck

Securities and Futures Commission (Hong Kong)

Ms. Alexa Lam

Commissione Nazionale per le Società e la Borsa  
(Italy)

Mr. Marcello Bianchi  
Ms. Nicoletta Giusto

Financial Supervisory Agency (Japan)

Mr. Toshi Kurosawa  
Mr. Hideo Oki  
Ms. Madoka Takahashi

Comisión Nacional del Mercado de Valores  
(Mexico)

Chairman Guillermo Babatz  
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Ontario Securities Commission (Ontario, Canada)

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Comissão do Mercado de Valores Mobiliários  
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Mr. Louis Morisset  
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Mr. Jose Manuel Portero  
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Financial Services Authority (United Kingdom)

Ms. Sally Dewar  
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Securities and Exchange Commission (United  
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U.S. Securities and Exchange Commission

**CODE OF CONDUCT FUNDAMENTALS FOR CREDIT  
RATING AGENCIES**



**THE TECHNICAL COMMITTEE OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**DECEMBER 2004**

**REVISED FEBRUARY 2008**

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## CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

### INTRODUCTION

Credit rating agencies (CRAs) can play an important role in modern capital markets. CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today – some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer's debt and debt-like securities.<sup>1</sup>

In September 2003, IOSCO's Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies.<sup>2</sup> The Principles were designed to be a useful tool for securities regulators, rating agencies and others wishing to articulate the terms and conditions under which CRAs operate and the manner in which opinions of CRAs should be used by market participants. Because CRAs are regulated and operate differently in different jurisdictions, the Principles laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of securities markets and reduce systemic risk. The Principles were designed to apply to all types of CRAs operating in various jurisdictions. However, to take into account the different market, legal and regulatory circumstances in which CRAs operate, and the varying size and business models of CRAs, the manner in which the Principles were to be implemented was left open. The Principles contemplated that a variety of mechanisms could be used, including both market mechanisms and regulation.

Along with the Principles, IOSCO's Technical Committee also published a Report on the Activities of Credit Rating Agencies that outlined the activities of CRAs, the types of regulatory issues that arise relating to these activities, and how the Principles address these issues.<sup>3</sup> The CRA Report highlighted the growing and sometimes controversial importance placed on CRA assessments and opinions, and found that, in some cases, CRAs activities are not always well understood by investors and issuers alike. Given this lack of understanding, and because CRAs typically are subject to little formal regulation or oversight in most jurisdictions, concerns have been raised regarding the manner in which CRAs protect the integrity of the rating process, ensure that investors and issuers are treated fairly, and safeguard confidential material information provided them by issuers.

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<sup>1</sup> CRAs typically provide credit ratings for different types of debts and financial obligations — including, for example, private loans, publicly and privately traded debt securities, preferred shares and other securities that offer a fixed or variable rate of return. For simplicity's sake, the term “debt and debt-like securities” is used herein to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

<sup>2</sup> This document can be downloaded from IOSCO's On-Line Library at [www.iosco.org](http://www.iosco.org) (IOSCPD151).

<sup>3</sup> This document can be downloaded from IOSCO's On-Line Library at [www.iosco.org](http://www.iosco.org) (IOSCPD153).



Following publication of the CRA Principles, some commenters, including a number of CRAs, suggested that it would be useful if IOSCO were to develop a more specific and detailed code of conduct giving guidance on how the Principles could be implemented in practice. The following Code of Conduct Fundamentals for Credit Rating Agencies is the fruition of this exercise. As with the Principles, with which it should be used, the Code Fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the public at large.<sup>4</sup>

The Code Fundamentals offer a set of robust, practical measures that serve as a guide to and a framework for implementing the Principles' objectives. These measures are the fundamentals which should be included in individual CRA codes of conduct, and the elements contained in the Code Fundamentals should receive the full support of CRA management and be backed by thorough compliance and enforcement mechanisms. However, the measures set forth in the Code Fundamentals are not intended to be all-inclusive: CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction, and the Technical Committee may revisit the Code Fundamentals in the future should experience dictate that modifications are necessary. Further, the Code Fundamentals are not designed to be rigid or formulistic. They are designed to offer CRAs a degree of flexibility in how these measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal and market circumstances.

IOSCO Technical Committee members expect CRAs to give full effect to the Code Fundamentals. In order to promote transparency and improve the ability of market participants and regulators to judge whether a CRA has satisfactorily implemented the Code Fundamentals, CRAs should disclose how each provision of the Code Fundamentals is addressed in the CRA's own code of conduct. CRAs should explain if and how their own codes of conduct deviate from the Code Fundamentals and how such deviations nonetheless achieve the objectives laid out in the Code Fundamentals and the IOSCO CRA Principles. This will permit market participants and regulators to draw their own conclusions about whether the CRA has implemented the Code Fundamentals to their satisfaction, and to react accordingly. In developing their own codes of conduct, CRAs should keep in mind that the laws and regulations of the jurisdictions in which they operate vary and take precedence over the Code Fundamentals. These laws and regulations may include direct regulation of CRAs and may incorporate elements of the Code Fundamentals itself.

Finally, the Code Fundamentals only address measures that CRAs should adopt to help ensure that the CRA Principles are properly implemented. The Code Fundamentals do not address the equally important obligations issuers have of cooperating with and providing accurate and complete information to the marketplace and the CRAs they solicit to provide ratings. While aspects of the Code

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<sup>4</sup> A consultation draft of the Code Fundamentals was published for public comment in October 2004. This document (IOSCOPD173) and a list of public comments IOSCO received on the consultation draft (IOSCOPD177) can be downloaded from IOSCO's On-Line Library at [www.iosco.org](http://www.iosco.org). The online version of the list of public comments includes hyperlinks to the comment letters themselves.

Fundamentals deal with a CRA's duties to issuers, the essential purpose of the Code Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO members recognize that credit ratings, despite their numerous other uses, exist primarily to help investors assess the credit risks they face when making certain kinds of investments. Maintaining the independence of CRAs vis-à-vis the issuers they rate is vital to achieving this goal. Provisions of the Code Fundamentals dealing with CRA obligations to issuers are designed to improve the quality of credit ratings and their usefulness to investors. These provisions should not be interpreted in ways that undermine the independence of CRAs or their ability to issue timely ratings opinions.

Like the IOSCO CRA Principles, the objectives of which are reflected herein, the Code Fundamentals are also intended to be useful to all types of CRAs relying on a variety of different business models. The Code Fundamentals do not indicate a preference for one business model over another, nor are the measures described therein designed to be used only by CRAs with large staffs and compliance functions. Accordingly, the types of mechanisms and procedures CRAs adopt to ensure that the provisions of the Code Fundamentals are followed will vary according to the market and legal circumstances in which the CRA operates.

Structurally, the Code Fundamentals are broken into three sections and draw upon the organization and substance of the Principles themselves:

- The Quality and Integrity of the Rating Process;
- CRA Independence and the Avoidance of Conflicts of Interest;  
and,
- CRA Responsibilities to the Investing Public and Issuers.

## **TERMS**

The Code Fundamentals are designed to apply to any CRA and any person employed by a CRA in either a full-time or part-time capacity. A CRA employee who is primarily employed as a credit analyst is referred to as an "analyst." For the purposes of the Code Fundamentals, the terms "CRA" and "credit rating agency" refer to those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities.

For the purposes of the Code Fundamentals, a "credit rating" is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. As described in the CRA Report, credit ratings are not recommendations to purchase, sell, or hold any security.

## THE IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

As described in the IOSCO CRA Principles, CRAs should endeavor to issue opinions that help reduce the asymmetry of information that exists between borrowers and debt and debt-like securities issuers, on one side, and lenders and the purchasers of debt and debt-like securities on the other. Rating analyses of low quality or produced through a process of questionable integrity are of little use to market participants. Stale ratings that fail to reflect changes to an issuer's financial condition or prospects may mislead market participants. Likewise, conflicts of interest or other undue factors – internal and external – that might, or even appear to, impinge upon the independence of a rating decision can seriously undermine a CRA's credibility. Where conflicts of interest or a lack of independence is common at a CRA and hidden from investors, overall investor confidence in the transparency and integrity of a market can be harmed. CRAs also have responsibilities to the investing public and to issuers themselves, including a responsibility to protect the confidentiality of some types of information issuers share with them.

To help achieve the objectives outlined in the CRA Principles, which should be read in conjunction with the Code Fundamentals, CRAs should adopt, publish and adhere to a Code of Conduct containing the following measures:

### 1. QUALITY AND INTEGRITY OF THE RATING PROCESS

#### A. Quality of the Rating Process

- 1.1 *The CRA should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology.*
- 1.2 *The CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.*
- 1.3 *In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA. Analysts should apply a given methodology in a consistent manner, as determined by the CRA.*
- 1.4 *Credit ratings should be assigned by the CRA and not by any individual analyst employed by the CRA; ratings should reflect all information known, and believed to be relevant, to the CRA, consistent with its published methodology; and the CRA should use people who, individually or collectively (particularly where rating committees are used) have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.*

- 1.5 *The CRA should maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable law.*
- 1.6 *The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.*
- 1.7 *The CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order make such an assessment. The CRA should adopt reasonable measures to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating. If the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the CRA should make clear, in a prominent place, the limitations of the rating and any risks associated with credit ratings of such products.*
- 1.7-1 The CRA should establish a review function made up of one or more senior managers with appropriate experience to review new methodologies as well as the feasibility of providing a credit rating for a new product.
- 1.7-2 The CRA should establish an independent function responsible for periodically reviewing the methodologies and models and changes to the methodologies and models it uses.
- 1.7-3 The CRA should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credit rating for the security that fits within its established categories of credit ratings, CRA should refrain from issuing a credit rating.
- 1.8 *The CRA should structure its rating teams to promote continuity and avoid bias in the rating process.*

## **B. Monitoring and Updating**

- 1.9 *The CRA should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings.* Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating by:

- a. *regularly reviewing the issuer's creditworthiness;*
- b. *initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology; and,*
- c. *updating on a timely basis the rating, as appropriate, based on the results of such review.*

*Subsequent monitoring should incorporate all cumulative experience obtained. Changes in ratings criteria and assumptions should be applied where appropriate to both initial ratings and subsequent ratings.*

*1.9-1 If a CRA uses separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner.*

*1.10 Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. Where a CRA's ratings are provided only to its subscribers, the CRA should announce to its subscribers if it discontinues rating an issuer or obligation. In both cases, continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.*

## **C. Integrity of the Rating Process**

*1.11 The CRA and its employees should comply with all applicable laws and regulations governing its activities in each jurisdiction in which it operates.*

*1.12 The CRA and its employees should deal fairly and honestly with issuers, investors, other market participants, and the public.*

*1.13 The CRA's analysts should be held to high standards of integrity, and the CRA should not employ individuals with demonstrably compromised integrity.*

*1.14 The CRA and its employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to a rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance and similar transactions.*

*1.14-1 A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.*

- 1.15 *The CRA should institute policies and procedures that clearly specify a person responsible for the CRA's and the CRA's employees' compliance with the provisions of the CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of the CRA's rating operations.*
- 1.16 *Upon becoming aware that another employee or entity under common control with the CRA is or has engaged in conduct that is illegal, unethical or contrary to the CRA's code of conduct, a CRA employee should report such information immediately to the individual in charge of compliance or an officer of the CRA, as appropriate, so proper action may be taken. A CRA's employees are not necessarily expected to be experts in the law. Nonetheless, its employees are expected to report the activities that a reasonable person would question. Any CRA officer who receives such a report from a CRA employee is obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the rules and guidelines set forth by the CRA. CRA management should prohibit retaliation by other CRA staff or by the CRA itself against any employees who, in good faith, make such reports.*

## **2. CRA INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST**

### **A. General**

- 2.1 *The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.*
- 2.2 *The CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.*
- 2.3 *The determination of a credit rating should be influenced only by factors relevant to the credit assessment.*
- 2.4 *The credit rating a CRA assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship.*
- 2.5 *The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise. The CRA should also define what it considers, and does not consider, to be an ancillary business and why.*



## **B. CRA Procedures and Policies**

- 2.6 *The CRA should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses the CRA makes or the judgment and analyses of the individuals the CRA employs who have an influence on ratings decisions. The CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.*
- 2.7 *The CRA's disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.*
- 2.8 *The CRA should disclose the general nature of its compensation arrangements with rated entities.*
- a. Where a CRA receives from a rated entity compensation unrelated to its ratings service, such as compensation for consulting services, the CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.*
- b. A CRA should disclose if it receives 10 percent or more of its annual revenue from a single issuer, originator, arranger, client or subscriber (including any affiliates of that issuer, originator, arranger, client or subscriber).*
- c. A CRA should disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating of that same product; or (2) contracts with the CRA for a final rating and does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.*
- 2.9 *The CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities.*
- 2.10 *In instances where rated entities (e.g., governments) have, or are simultaneously pursuing, oversight functions related to the CRA, the CRA should use different employees to conduct its rating actions than those employees involved in its oversight issues.*

## **C. CRA Analyst and Employee Independence**

- 2.11 *Reporting lines for CRA employees and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest.*

- a. The CRA's code of conduct should also state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.
  - b. The CRA should conduct formal and periodic reviews of compensation policies and practices for CRA employees to ensure that these policies and practices do not compromise the CRA's rating process.
- 2.12 The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.
- 2.13 No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee:
- a. Owns securities or derivatives of the rated entity, other than holdings in diversified collective investment schemes;
  - b. Owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes;
  - c. Has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest;
  - d. Has an immediate relation (i.e., a spouse, partner, parent, child, or sibling) who currently works for the rated entity; or
  - e. Has, or had, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.
- 2.14 The CRA's analysts and anyone involved in the rating process (or their spouse, partner or minor children) should not buy or sell or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified collective investment schemes.
- 2.15 CRA employees should be prohibited from soliciting money, gifts or favors from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.
- 2.16 Any CRA analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic



responsibility), should be required to disclose such relationship to the appropriate manager or officer of the CRA, as determined by the CRA's compliance policies.

2.17 The CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated, or a financial firm with which the CRA has significant dealings.

### **3. CRA RESPONSIBILITIES TO THE INVESTING PUBLIC AND ISSUERS**

#### **A. Transparency and Timeliness of Ratings Disclosure**

- 3.1 *The CRA should distribute in a timely manner its ratings decisions regarding the entities and securities it rates.*
- 3.2 *The CRA should publicly disclose its policies for distributing ratings, reports and updates.*
- 3.3 *The CRA should indicate with each of its ratings when the rating was last updated. Each rating should also indicate the principal methodology or methodology version that was used in determining the rating.*
- 3.4 *Except for "private ratings" provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.*
- 3.5 *The CRA should publish sufficient information about its procedures, methodologies and assumptions (including financial statement adjustments that deviate materially from those contained in the issuer's published financial statements and a description of the rating committee process, if applicable) so that outside parties can understand how a rating was arrived at by the CRA. This information will include (but not be limited to) the meaning of each rating category and the definition of default or recovery, and the time horizon the CRA used when making a rating decision.*
  - a. Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.
  - b. The CRA should disclose whether it uses a separate set of symbols when rating structured finance products, and their reasons for doing so or not doing so. In any case, a CRA should clearly define a given

rating symbol and apply it in a consistent manner for all types of securities to which that symbol is assigned.

c. The CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the limits to which the CRA verifies information provided to it by the issuer or originator of a rated security.

- 3.6 When issuing or revising a rating, the CRA should explain in its press releases and reports the key elements underlying the rating opinion.
- 3.7 Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response. Where in particular circumstances the CRA has not informed the issuer prior to issuing or revising a rating, the CRA should inform the issuer as soon as practical thereafter and, generally, should explain the reason for the delay.
- 3.8 In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how rating categories have changed, and be able to draw quality comparisons among ratings given by different CRAs. If the nature of the rating or other circumstances make a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this. This information should include verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.
- 3.9 For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.
- 3.10 Because users of credit ratings rely on an existing awareness of CRA methodologies, practices, procedures and processes, the CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. Where feasible and appropriate, disclosure of such material modifications should be made prior to their going into effect. The CRA should carefully consider the

*various uses of credit ratings before modifying its methodologies, practices, procedures and processes.*

**B. The Treatment of Confidential Information**

- 3.11 The CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement and consistent with applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases, through research conferences, to future employers, or in conversations with investors, other issuers, other persons, or otherwise.*
- 3.12 The CRA should use confidential information only for purposes related to its rating activities or otherwise in accordance with any confidentiality agreements with the issuer.*
- 3.13 CRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the CRA from fraud, theft or misuse.*
- 3.14 CRA employees should be prohibited from engaging in transactions in securities when they possess confidential information concerning the issuer of such security.*
- 3.15 In preservation of confidential information, CRA employees should familiarize themselves with the internal securities trading policies maintained by their employer, and periodically certify their compliance as required by such policies.*
- 3.16 CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA, except to the issuer or its designated agents.*
- 3.17 CRA employees should not share confidential information entrusted to the CRA with employees of any affiliated entities that are not CRAs. CRA employees should not share confidential information within the CRA except on an “as needed” basis.*
- 3.18 CRA employees should not use or share confidential information for the purpose of trading securities, or for any other purpose except the conduct of the CRA’s business.*

**4. DISCLOSURE OF THE CODE OF CONDUCT AND COMMUNICATION WITH MARKET PARTICIPANTS**

- 4.1 *The CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. The CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.*
- 4.2 *The CRA should establish a function within its organization charged with communicating with market participants and the public about any questions, concerns or complaints that the CRA may receive. The objective of this function should be to help ensure that the CRA's officers and management are informed of those issues that the CRA's officers and management would want to be made aware of when setting the organization's policies.*
- 4.3 *A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.*