The role of credit rating agencies in structured finance

CONSULTATION PAPER

(Answers to the questionnaire of the CESR)

80. **Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?**

Yes.

There is little doubt that the CRAs are fully aware of the inappropriate use that some investors - particularly those with the least experience – make of the ratings they publish. Since they are the first to underline that the risk of harming their reputation is the most important safeguard protecting investors, it is of paramount importance that they publicise continuously the limitations of their ratings.

As a first important step towards clarification, CRAs should most certainly develop a separate rating scale for structured finance as distinct from corporate finance. This step alone would permit a clear presentation of the differences of the two categories of ratings and thus avoid inappropriate transference of characteristics applicable to corporate ratings, with their long lived historical record, to structured ratings. A different rating scale would encourage investors to refer specifically to the underlying methodology involved in the structured rating process as part of their own internal suitability assessment.

A disclaimer listing the limitations appropriate for the type of rating should be incorporated in the header of each rating report.

83. CRAs make their methodologies freely available and there has been improvement since the introduction of the IOSCO Code. However, CESR believes that further progress by the CRAs in improving the accessibility of the information they provide is extremely important to creating greater transparency and encouraging appropriate use of credit ratings.

I agree.

A specific improvement could consist in referencing the relevant sections of the general methodology followed (which are available on the Webb sites) in each specific rating report as well as their updates. In addition, special factors (if any) concerning the structure being rated should be listed.

In addition to the obligations of CRAs in this respect, an useful clarification of the implementing rules of the Prospectus Directive should require that any reference to the rating in documents used by the issuer, arranger and/or distributor of the securities should be accompanied by an appropriate reference to the availability of the full rating report and a strong recommendation to refer to it.

90. Do you agree with CESR's view that although there has been improvement in transparency of methodologies, the accessibility and content of this information for complex structured finance products requires further improvement in particular so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings?

Yes.

The disclosure of underlying assumptions and parameters for stress tests should be made public and not be considered as proprietary.

Their disclosure should induce CRAs to ensure greater coherence when explaining a rating change and allows a better assessment of their competitive performance as their respective historical records build over time.

97. Do you agree that there needs to be greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as rating reviews?

Yes.

This could be easily achieved in requiring the implementation of suggestions included in the comments to § 83 here above.

100. Do you agree that there needs to be greater public and standardised information on structured products in the EU? How would this best be achieved?

Yes and No.

Yes to the extent that there should be a **"minimum standard"** concerning the "type" of information to be disclosed both at the time of the initial offering/rating and on an ongoing basis. This would cover for instance the elements of the basic methodology and their subsequent alteration(s), information concerning underlying assets and their ongoing performance, monitoring arrangements and review triggers, credit enhancement mechanisms (if any) and their ongoing relevance (ratings of credit insurers). This standard could be implemented by introducing **"disclosure requirements"** on the model of those contained in the Prospectus Directive.

No to the extent that fundamental characteristics of structured finance are the tailoring of each transaction to meet specific objectives, the inherent greater degree of complexity involved and, consequently, the absence of direct "comparability" with a sufficiently

large sample of other market instruments. Excessive standardisation risks encouraging laxity among investors who might feel more inclined to rely on ratings without carrying out their own due diligence.

104. Do you agree with CESR that contractually set public announcements on structured finance performance would not add sufficient value to the market to justify the cost and possible saturation of the market with non-material information?

Yes

However, the mechanism of automatic reviews applicable to each structure should be disclosed in the rating report. In addition, there should be an obligation of making public the initiation of a rating review triggered by the breach of criteria.

112. Do you agree that the monitoring of structured finance products presents significant challenges, and therefore should be a specific area of oversight going forward? Are there any particular steps that CRAs should take to ensure the timely monitoring of complex transactions?

Yes

There can be however several acceptable business models. One alternative is to dissociate the staff monitoring performance from the initial rating team. This approach helps in reducing one of the real or perceived areas of conflicts of interest.

Another is to allocate the monitoring to the initial rating team but to dissociate, when required, the review of the methodology. The latter should be initiated automatically if a significant number of similar structures showed a common pattern of transgressions of trigger levels.

By dissociating the review of the methodology from that of the rated structures directly concerned, one can ensure greater objectivity in determining whether the transgressions need only to be taken into account by a change in the rating (without any change in methodology), or whether unforeseen circumstances have changed the environment necessitating a reappraisal of the basic rating criteria.

In order to ensure timely disclosure of rating reviews, the basic principle should follow generally accepted rules such as:

- The absence of announcement within a period of say 6 weeks, after each automatic monitoring exercise would indicate “no change”.
- An announcement of a breach of “rating” triggers should lead to one of two possibilities :

a) The announcement of a review within existing criteria leading to a possible change with indication of the bias The confirmation of the change, if any, should occur rapidly, within say 2 weeks maximum.
b) The announcement of a review coupled with the possible change in methodology. In this case the bias on the basis of "unchanged methodology" should be indicated as under a). The confirmation of the change in rating and methodology should be confirmed within a longer period (say 8 weeks maximum).

- When a change in methodology is announced, it should be accompanied by a list of the rated structures to which it would apply and confirmation of the "new" ratings should follow on within say 4 weeks.

Having no personal experience in the management of CRAs, the suggested time frameworks mentioned here above are purely illustrative. Each CRA should clearly remain free to select its own business model for allocating resources and establishing an appropriate time frame for publicising its ratings. The time frame selected should be disclosed publicly. It could vary in accordance with the characteristics of the class of security involved though each rating would be from the outset associated with the specific time schedule applicable to its class.

The suggestions here above should not be construed in any way as inhibiting CRAs from derogating to the procedures should circumstances warrant their acceleration in order to improve market transparency.

118. Do you believe that the CRAs have maintained sufficient human resource, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business?

Cannot judge.

The CESR should not be concerned by the effective **"level"** of human resources in each CRA as it is clear that it depends, among other factors, on the business model retained. The CESR should concentrate on monitoring whether the CRAs are able to meet the standards imposed by the code of conduct and other rules/regulations and procedures that they might consider appropriate.

While it is understandable that CRAs may wish to keep confidential most of the elements concerning human resource management, they should nevertheless be able to indicate the case workload that can be efficiently managed by a single individual or a team based on averages and taking into account variables such as: initial/monitoring rating, standard/innovative structure, transparent/opaque structure etc. It should however be recognised that these levels change rapidly over time with the improvements in information management communications and other innovations that are inherent to the business.

The argument put forward by the CRAs that their main asset is their reputation should be reason enough for ensuring that adequate staffing levels are maintained both from a quantitative and qualitative point of view.

120. Do you consider that the generally unaltered educational and professional requirements of CRAs' recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

Not necessarily.

The rating process is not an exact science. Experience, judgement, knowledge of markets are as important (if not more) than the ability to juggle with complex mathematical and statistical models, (which are often not understood by those charged with the responsibility of oversight). The specificity of the rating business makes it far easier to train an individual with appropriate business experience to become an analyst than to provide a graduate out of university with the necessary judgemental skills required in the process. The complexity of the process is better addressed by a “team approach” where specific knowledge in different areas (accounting, engineering, legal, as well as modelling) can be combined.

125. Do you agree there is a need for greater transparency in terms of CRA resourcing?

No

This is a matter for each CRA. Credibility is not achieved by staff numbers. By insisting on full disclosure, one could create the false impression that quality is dependant on size.

Credibility is built up only by creating over time a “track record” of correct ratings and timely adjustments. In this regard, one should refer to the comments on §80. CRAs should handle references to track records built in the area of **corporate finance ratings** as a demonstration of their know-how with extreme care. This aspect may not have been given appropriate attention and may have misled investors– by omission – creating an excessive reliance on ratings issued by established CRAs in the structured finance area.

126. Do you agree with CESR that more clarity and greater independence is required for analyst remuneration at the CRAs?

This question has been extensively reviewed within the context of consultation by the European Commission and the CESR concerning the remuneration of financial analysts within investment banks and other providers of securities services. While it is important to understand the nature of potential conflicts of interest that may surface within CRAs specifically, the conclusions drawn by these reports should apply broadly to the question of compensation of rating analysts.

133. Do you see the level of interaction between the CRAs and issuers of structured finance products creating additional conflicts of interest for the CRAs to those outlined above? Do you believe that any of these conflicts are not being managed properly?

There are significant differences between corporate finance and structured finance ratings.

First of all, structured ratings are issued normally by only **one** CRA while corporate ratings are often rated by at least two CRAs on an either solicited or unsolicited basis. This is possible in the corporate market because revenues of CRAs are generated by both issuers **and** investors while in the structured area only issuers/arrangers foot the bill. The competitive environment, already limited by the oligopolistic nature of the rating market, is exacerbated in the structured area where each mandate is a "winner takes all". It is clear that the potential for a conflict of interest is heightened, though its nature is not fundamentally different than in the corporate rating market.

Another important factor is the fundamental difference between the two types of rating due to the different level of control exercised by the parties on its key elements. Having recognised this fact, the description of the role of the CRA in structured finance as being advisory (or not) seems largely semantic.

In and of itself, the preliminary shadow rating provided by the CRA in the early stages of a deal, is part of the necessary process to ensure the successful marketing of a given issue of securities. Being part of the rating process itself, it is not comparable with the situation that existed within accounting firms where advisory and accounting services were distinct from each other in nature but where a favourable "accounting treatment" might be expected in exchange of a juicy advisory mandate.

There seems to be no particular reason to believe that the prominence acquired by structured finance in the rating market creates **additional** conflicts though resources allocated to their strict monitoring, deriving from the additional volume of business, should be made available.

134. Do you agree that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers with regards to structure finance products and that there needs to be clearer definitions of acceptable practice?

Not particularly.

What might be useful in this area is the implementation of the recommendation contained in the comments to §83 here above, concerning the inclusion in the Prospectuses of detailed references to the rating material regarding structured securities.

Indeed, while such precaution might not seem indispensable for corporate ratings, a heightened awareness of the availability of the specific rating report pertaining to the issue could improve transparency.

138. Do you believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business?

Yes.

Consulting services such as pricing services or credit assessments should not be performed in favour of clients who have issued/arranged the securities being priced or assessed in order to avoid the type of conflict that existed within the auditing profession.

142. Do you believe that the fee model used for structured finance products creates a conflict of interest for the CRAs? If yes, is this conflict of interest being managed appropriately by the CRAs?

No.

The contingent aspect of the fee base on the completion of the issue is partly a compensation for the high level of the fees charged in the first place. This is a choice that should be entirely left to the marketing model adopted by the CRAs.

By improving disclosure requirements on the methodology applicable to an issue, one reduces considerably the risk of conflict of interest. This is particularly true in the structured finance area as objective parameters are used to far greater extent than the more subjective judgements included in corporate ratings (quality of management, assessment of competitive environment, evaluation of quality of R & D etc.).

146. Do you agree with CESR that there needs to be greater disclosure of fee structures and practices with particular regard to structured finance ratings so as to mitigate potential conflicts of interests?

Yes and No.

Though not to mitigate potential conflicts of interest but for sake of transparency, the actual fees paid to a CRA for the initial and ongoing ratings should be disclosed in the Prospectus along with all other expenses relating to the issue. There does not appear to be a need to disclose a “break up fee” as no security is issued to the public.

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164. Do you agree with CESR's view of the benefits and costs of the current regime?

Partly.

One of the key advantages of the current regime, in addition to the obvious savings in costs linked to legislating and implementation is that it removes from the Regulator the burden of the **"responsibility".**

In a sphere where the market participants appreciate at its full value the "independence" of the CRAs, a constraining regulatory environment could turn out to be counterproductive.

In light of the oligopolistic features of the market, I do not believe that the creation of an industry body to interface with Regulators would be of great value but would just add an unnecessary level of complication with its attendant confidentiality, cost and staffing problems. This question could be usefully reviewed within the framework of the EU/USA dialogue on financial regulatory matters.

170. Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

Largely.

I strongly disagree that a regulatory regime would be an incentive "to avoid future failings in the rating process". Regulation is by nature totally incapable of ensuring quality outcomes in a process such as ratings. Should it attempt to do so it would only weaken the credibility/usefulness of CRAs.

Effective regulation must include enforcement powers. This implies that the necessary budgetary resources are allocated to make them credible. The history of enforcement by financial market authorities in the EU has to date been one of its weakest areas. All too often there has been an attempt to correct market failures by additional legislation/regulation when adequate enforcement of existing rules could have been sufficient. Transgression of rules which does not lead to redress breeds a feeling of impunity (this is much less the case in the United States).

177. Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation?

I believe that the best approach is to reinforce the powers of IOSCO giving it the responsibility monitor, "blame and shame" publicly and, if necessary sanction transgressions by organisations subscribing to its Code. It should also have the obligation to inform Regulators of such transgressions.

Rather than a formal ex ante “recognition” procedure, the Regulators should have the ultimate power to sanction CRAs that are in breach of IOSCO rules by subjecting them to a formal “injunction” that would impose specific obligations. Failure to comply could lead to fines and/or restrictions on operations permitted within the EU.

Addendum:

In the introductory analysis of the Consultation Document, the CESR refers clearly to the fact that in their rating analysis, CRAs specify that they do not include an evaluation of the liquidity or price of the assets underlying the securities being rated. This stance has the advantage of clarity and is meant to induce investors to complete their assessment of the merits of a commitment.

One should however raise the question as to the appropriateness of this approach by CRAs in the case of “cascades” of structured securities (DCOs for example). Indeed, the immediate underlying asset is no longer the house being mortgaged (the price and liquidity of which is not addressed), but rather the RMBS which is itself a structured security.

Any analysis that overlooks the liquidity and price fluctuations of RMBS securities in the rating of DCOs as key parameters seems to be incomplete and should not be an acceptable excuse for not anticipating possible weaknesses of the structure. Failing to address this aspect will clearly reduce considerably the “usefulness” of the rating attributed to structured vehicles which are themselves based on the value of other structured securities.

This remark underlines, once again, the importance of dissociating traditional corporate finance ratings from structured finance ratings as recommended in comments to § 80 here above. This should help avoiding the un-expressed implication that fundamental aspects applicable to the well known sphere of traditional ratings are automatically transferable to the newer and less well understood world of structured finance ratings.

Paul N. Goldschmidt
Director, European Commission (ret.)

Brussels, 16 February 2008