Standard & Poor's Ratings Services response dated 31 July 2007 to CESR questionnaire regarding the rating of structured finance instruments

Introduction

Standard & Poor's Ratings Services ("Ratings Services") welcomes the opportunity to comment on the "Questionnaire regarding the Rating of Structured Finance Instruments" ("the Questionnaire"), as published by the Committee of European Securities Regulators ("CESR") on 22 June 2007.

Ratings Services has, from the outset, supported the approach taken by the European Commission involving a voluntary self-regulatory process for credit rating agencies under general market and regulatory oversight. Ratings Services looks forward to continuing to engage with the CESR Taskforce as it works towards preparation of its second annual report to the European Commission on credit rating agencies compliance with the December 2004 IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

The comments provided below are intended to address as concisely as possible the matters raised in the Questionnaire. Where appropriate, references to publicly released articles have been provided. Those articles have also been incorporated into this response as attachments.

By way of general introduction, and with a view to providing context for the matters discussed in this response, we would point out that, at their most basic level, structured financings legally isolate assets from any previous owner's insolvency, to enable a purchaser of securities backed by those assets to rely solely on the creditworthiness of those assets and accompanying credit enhancement, if any.

In this way the structure seeks to insulate payment on the structured finance securities from the risk of default of any such previous owner that is unrated or has a credit rating lower than the desired rating of the structured financing. In other words, Ratings Services is able to base its ratings on the credit aspects of the isolated assets or asset pools, without regard to the creditworthiness of any previous owner, seller or contributor of the assets.

Ratings Services' credit analysis generally addresses (1) the credit quality of the pool of securitised assets (2) the structural and legal risks of the transaction (3) the payment structure and the cashflow mechanics of the securities (4) relevant operational and administrative risks and (5) any other sources of payment for the securities - for example guarantees, swaps, or other forms of credit support for the transaction. This analysis enables Ratings Services to reach an opinion as to the creditworthiness of the structured finance security, commonly categorised as an opinion as to the future likelihood of the payment of principal and interest on the security in accordance with its terms.

Ratings Services' analysts review information submitted by participants in the transaction, for example issuers, originators, underwriters, servicers and trustees. In addition, a range of quantitative techniques and models is used to enhance analysts' understanding of the performance of the transaction. During the rating process the transaction participants usually refine transactional elements (relating to credit and structure) to reach the final structure and credit profile of the transaction and may submit additional or revised information for review. The analyst evaluates the information and prepares a recommendation for the rating committee.

The structured finance group in Ratings Services also rates credit derivatives which are also known broadly as "*synthetic Collateralised Debt Obligations*". These are derivative contracts through which one party "*sells protection*" and its counterparty "*buys protection*" on a credit obligation or a pool of credit obligations. At its simplest level, if one or more of the credits which is the subject matter of the contract defaults, the protection seller must pay an amount to the protection buyer. Credit derivatives are a form of credit insurance. Credit derivatives are usually legally simpler contracts which do not involve the sale of assets or forms of complex credit support or liquidity support.

To determine a rating, a rating committee is convened comprised of Ratings Services' personnel who bring to bear particular credit experience and/or structured finance expertise relevant to the rating. The qualitative judgments of the committee are an integral part of the rating process as it is through this process that asset- and transaction-specific factors, as well as changes in the market and environment, can be best assessed and addressed in the rating outcomes.

Once a rating is determined by the rating committee, Ratings Services notifies the originator and the arranger and, if it is a public rating, disseminates the rating to the public for free by posting it on the Standard & Poor's public website[1]. Along with its public ratings, Ratings Services frequently publishes a short narrative rationale authored by the lead analyst. The purpose of this rationale is to make public the basis for Ratings Services' analysis and enhance transparency to the marketplace.

After a rating is assigned (other than confidential ratings specifically requested and identified in the rating letter as being without surveillance, as described below), it is monitored or "surveilled" by Ratings Services to adjust for any developments that would impact the original rating. The purpose of this surveillance process is to ensure that the rating continues to reflect Ratings Services' credit opinion based on the original assumption of the future performance of the transaction. The surveillance process varies based on Ratings Services' assessment of risks to the transaction. If information leads the surveillance analyst to believe a rating change is warranted, the analyst will present the information to a rating committee, which will then determine whether the rating should be changed. When a change to a public rating is anticipated or occurs, the analysts similarly publish the new rating and a related ratings rationale.

Ratings Services has a long-standing policy of providing its public credit ratings updates and the basis for those updates broadly to the investing public as soon as possible and without cost. They are disseminated via real-time posts on the Standard & Poor's public website and through a wire feed to the news media, as well as through Standard & Poor's subscription services.

[1] www.standardandpoors.com

Studies on rating trends have repeatedly shown that there is a clear relationship between the initial rating assigned by Ratings Services and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa.

For structured finance transactions, Ratings Services' "*Global Structured Finance Default Study*" published in January 2007 (a copy is attached to this response for ease of reference) shows that the relationship between ratings and observed default rates was consistent with expectations. The average one-year default rates since 1978 were near zero (0.04%) for investment-grade securities and 2.33% for speculative-grade securities. The same pattern prevailed across two to five year periods while the default rates were increasing. For example, the average five- year default rate for investment-grade securities was 0.87% - and 15.42% for speculative-grade securities. Specifically, for the last five years (beginning in January 2002 and ending in December 2006), the five-year default rate for structured finance securities rated investment-grade globally was 1.29%, compared with 16.92% for structured finance securities rated speculative-grade.

Organisation

1. What proportion of your total rating revenue comes from structured finance related activity?

2. Do you offer non rating "ex post" services related to structured finance products (i.e. pricing or valuation models,)? If yes, what proportion of your total structured finance derived revenue comes from those ancillary/advisory services?

3. Please describe any specificities of the way you determine your fees for the rating of structured finance products as compared to the fees charged in corporate ratings.

4. How are the fees you charge for any "ex post" ancillary/advisory activities determined – are they determined separately from fees relating to the actual rating?

5. How is staff remuneration determined for structured finance ratings analysts? Is this different staff from staff that work on related ancillary/advisory services?

Ratings Services' responses

2. While on reflection it is somewhat unclear what services Question 2 refers to, Ratings Services does offer services related to structured finance products in addition to credit ratings, such as, for example, models allowing market participants to evaluate and optimise potential securitisation structures with the same tools used by Ratings Services' analysts - and products providing an insight into Ratings Services' surveillance process in relation to certain transactions. For the purposes of this response, Ratings Services treats "*surveillance fees*" (which are annual payments for rated transactions to cover the costs of surveilling existing ratings) as part of the ratings fees since such surveillance is necessary to maintain the rating and in no way represents a fee for "*ancillary*" services. Surveillance is an automatic part of the rating, not an optional service.

Ratings Services structured finance group does not provide any "*advisory services*".

3. Fees charged in structured finance ratings are "*transactional fees*" – i.e. they are charged on a transaction by transaction basis. They are usually paid out of the proceeds of the bond issuance and therefore will usually be paid, from an effective economic point of view, by the "*originator*"[2].

Fees charged are usually expressed in terms of "*basis points*" of the size of the securitisation issue. The quantum of the fee is determined on a transaction by transaction basis, but usually follows traditional price points. Fees may be charged which depart from traditional price points in the case of new and innovative transactions requiring additional and high value added work. Fees may also be subject to commercial negotiations with clients who may, for example, wish to have a discount if they are frequent issuers. Fees are also often subject to "*cap*" arrangements, so that when transactions are over a certain agreed size the fee is capped at an agreed level.

[2] A typical securitisation will see assets transferred from a corporate institution (usually a financial institution) to a special purpose entity whose sole activity is the purchase of these assets and the issuance of securitisation bonds. The special purpose entity is, from a technical legal point of view, the "*issuer*". The entity that was the original owner of the assets and that receives the proceeds of the issue of the securitisation is called the "*originator*".

This is distinct from traditional pricing for corporate ratings where an annual fee is usually agreed and where the annual fee is expressed in basis points of the client's issuance that year.

4. Subject to the same point referred to in the response to Question 2 above, fees for services related to structured finance products which Ratings Services offers in addition to credit ratings, are determined separately from any fees related to credit ratings. Usually they are purchased entirely separately from any rating by clients who may or may not be "*ratings clients*". Accordingly, there is no connection between such fees and any "*ratings*" fees.

5. The individual compensation of structured finance ratings analysts does not depend on the number of ratings that they manage, the specific level of ratings assigned or the revenue directly generated by those ratings.

Rating process

6. Is the organisation of the rating process similar for corporate and for structured products? If not, please explain the differences.

7. Which parties does your firm liaise with directly as part of the rating process? Are there clear policies governing how this relationship is conducted?

8. What information about the remuneration for providing the rating is provided to the various parties to the deal?

9. Please describe any specificity regarding your policy of publication of ratings in the structured finance segment.

Ratings Services' responses

6. The organisation of the process for assigning a rating is fundamentally the same for corporates and structured finance products. In each case a primary analyst is assigned to the rating. The primary analyst gathers all the information that he or she believes is

necessary to assign the rating. The analyst is also in a dialogue with the client as to required information. The analyst usually, for both corporates and structured finance, provides feedback to the client as to the likely rating of the corporate or, as the case may be, the structured finance transaction. The analyst will then, in both cases, convene a rating committee which will determine the rating. Once the rating is determined, the client will be informed.

The differences between the two ratings lie in the identity of the client and in the frequency - but not the nature - of the interaction.

Thus, in a corporate rating, the client with whom a dialogue takes place is usually the issuer, although the issuer may be assisted by an investment bank. As noted above, in structured finance the issuer is not a meaningful entity but a special purpose company. The dialogue then tends to take place with either the originator or the investment bank hired by the originator. In the case of originators who are frequent "*issuers*" in the structured finance market and therefore have a great familiarity with its complexities, the dialogue will usually be conducted between the analyst and such an originator. In many cases, though, the originator does not feel familiar enough with structured finance so the dialogue is conducted between the analyst and the investment bank mandated by the originator for the transaction in question.

7. As set out above, the primary relationship is most often with the investment bank mandated by the originator. In the case of originators that are sophisticated and frequent users of structured financings, the relationship would usually be with the originator. In addition, Ratings Services rates the issuance of special structured finance arbitrage vehicles (e.g. "*Structured Investment Vehicles*" or "*SIVs*"). In those cases, the relationship is with the management company that runs the vehicles.

Ratings Services' Code of Conduct ("the Code of Conduct") and its policies regarding the ratings process apply to Ratings Services in its entirety. These published policies address, among other things, the analytical process and the interaction with rated entities and their representatives.

8. The originator who usually pays the fees, whether directly or indirectly, as well as the investment bank mandated to arrange the issuance will be aware of the fee. The

negotiation as to the quantum of that fee may take place directly with the originator or through the mandated investment bank.

Neither the primary analyst nor any voting member of the committee will take part in the negotiation of the fee. This is stipulated in the Code of Conduct.

9. As referred to above, Ratings Services' policy of publication of ratings in the structured finance segment mirrors that in the corporate and governments segment.

Rating methodologies

10. How do you adapt your methodologies to market developments? Have you changed them recently? How do you apply the changes to the surveillance of rated transactions?

11. Do you consider that the track record of your ratings of structured finance products supports the appropriateness of your models?

12. To what extent can another rating agency's underlying ratings be incorporated into a structured finance rating by your firm? Are they treated in the same way as your own underlying ratings? Are there any risks emerging from the use of another agency's ratings?

Ratings Services' responses

10. Ratings Services reviews its methodologies, criteria and assumptions on an ongoing basis in order to account for significant market developments including, amongst others, innovative financing structures and instruments and developments in financial reporting and in risk management.

It should be stressed that the universe of structured finance criteria and assumptions is vast. These criteria range from very fundamental principles, applicable to many if not all structured finance transactions, to very precise criteria which apply only to a small but relevant part of certain types of transactions. For example, Ratings Services applies criteria and assumptions to determine whether the assets have been truly isolated from an originator in the case of that originator's bankruptcy. This is a "*macro-criteria*" applicable to almost all securitisation transactions. At the other end of the spectrum, Ratings Services has criteria to measure, for example, the risk of the application of German trade tax to certain kinds of transactions involving certain types of (but not all) German originators. It is important to note that jurisdiction-specific criteria and assumptions may in some circumstances be critical, particularly where asset performance and legal conditions vary from jurisdiction to jurisdiction. Ratings Services also has "*swap criteria*" that only apply to the terms and conditions of certain kinds of swaps when they are relevant to the rating outcomes.

Due to the continuing development of structured finance in new asset classes, new jurisdictions and new structures, Ratings Services' structured finance criteria and assumptions are constantly evolving. In addition, Ratings Services will adapt existing criteria and assumptions if there has been a development in the market warranting a re-examination of such criteria and assumptions. For example, new market data or changes in relevant law will lead to such a re-examination.

From a formal point of view, in 2005 Ratings Services initiated a process for obtaining market feedback on certain major criteria and policy actions. Ratings Services has requested comments on several criteria or policy issues.

Criteria are developed within Ratings Services' global and regional criteria committees. These committees are subject to Ratings Services' Analytics Policy Board oversight. This structure helps to facilitate consistent criteria development and application.

As a matter of information, Ratings Services' ratings are never purely based on a model (models may be used, for example, to size the credit enhancement or stress the ability of cashflow waterfalls to repay debt under a variety of scenarios). All ratings are the product of a committee process. This process is designed to allow analysts to raise any views they may have, including any issues connected to the output of any model. Ratings Services considers that this qualitative element is a fundamental component of the rating. In particular, such a qualitative element is designed to prevent market participants from "*gaming*" the rating models. It also allows the rating process to catch situations where the output of any given model appears illogical. Ratings Services strongly believes that "*principles-based ratings*" are superior to "*rules-based ratings*". In addition, most structured financings contain many elements which are relevant to the credit risk but not encompassed in any model - these would include legal and structural elements.

11. Attention is drawn to the default and transition tables set out in the articles attached to this response, which Ratings Services believes provide evidence that these models, together with the other analytical inputs which are part of the ratings, are appropriate.

12. In rating structured finance transactions, Ratings Services may in its sole discretion take into account public ratings produced by another rating agency. Ratings Services believes that, in evaluating the creditworthiness of structured products, it must understand the credit quality of all the underlying assets which are typically the sole source of payment for the structure's debt and there are several ways to do this. Where the underlying assets (for example corporate bonds held by the structured vehicle) have previously been rated by Ratings Services, then those existing ratings will be used in the analysis of the securities of the overall structure. However, if the underlying assets have not already been rated by Ratings Services, there are several alternatives. For example, Ratings Services may perform an analysis of the underlying assets without assigning a rating on them or may incorporate other information about the credit quality of those assets (including ratings by other rating agencies).

Relying on other agencies' ratings presents a significant risk since Ratings Services may effectively be asked to rate a structured product based in part on the analytical work and opinions of another rating agency, but without any input into that work or access to the reasons or means by which they arrived at the rating. Ratings Services and its analytical reputation would thus be subject to criticism and potential liability for the work of others.

As a result of the above risk, Ratings Services is reluctant to use other rating agencies' ratings except as a starting point for a small portion of the pool of underlying assets in certain types of transactions. However, to account for, among other matters, the analytical and surveillance practice differences amongst rating agencies – and the possibility that these assets could be downgraded by the other rating agencies at any time without notice to Ratings Services – Ratings Services reserves the right to discount the ratings of other agencies when incorporating them into its independent analysis.

On-going surveillance of the transactions

13. How do you monitor rated structured products? What are the main inputs into your review process?

14. Is there any difference between corporate credit ratings and structured finance ratings in terms of the frequency (ie. happen more often) and magnitude (ie. are larger) of rating amendments?

15. Is the internal process for amending a structured finance rating similar to the one for amending a corporate rating?

Ratings Services' responses

13. Consistent with its goal of forward-looking, timely and credible credit opinions, Ratings Services maintains surveillance on all public and confidential credit ratings, with the exception of confidential credit ratings specifically requested and identified in the rating letter as being without surveillance. The frequency and extent of surveillance is dynamic and reflects, among other things, the frequency and public availability of financial and regulatory reporting; the frequency and availability of transaction-specific performance information; the availability of new information, derived from a variety of sources, relevant to creditworthiness; and specific risk considerations and expectations relevant to an individual, group or class of rated entities.

Ratings Services has a dedicated team of surveillance analysts covering the European structured finance market. The team monitors outstanding structured finance transactions on an ongoing basis, taking timely rating actions when necessary. Additional background is provided in the attached article "*European Structured Finance Surveillance – Principles behind Rating Changes*", dated 11 June 2007.

14. The rating transitions among European structured finance securities were benign in 2006. Of the 6,145 ratings outstanding at the start of 2006, 96.5% remained stable or were raised, while only 3.5% were lowered. This compares with 97.4% and 2.6%, respectively, in 2005. The upgrade rate also rose, to 6.3% in 2006 from 4.3% in 2005. More background analysis is provided in the attached article, "*2006 Sees Upgrades Dominate For Third Successive Year In European Structured Finance*". A comparison between transition rates in structured finance relative to corporate ratings is drawn in the attached article, "*Annual 2006 Global Corporate Default Study and Ratings Transitions*"[3].

15. There are no fundamental differences between the internal processes for changing a structured finance rating and a corporate rating. In both cases, such changes are the result of a rating committee broadly similar in function to the committee that assigned the original rating.

<u>Potential conflicts of interest</u>

16. Do you think that the iterative process inherent in rating structured finance transactions may involve additional conflicts of interest compared to those arising in corporate ratings? If yes, how your firm is organised and what additional measures do you have in place to manage those potential conflicts?

17. Do you perceive any potential conflicts of interest between the structured rating activity and any ancillary/advisory services mentioned in question 2?

<u>Ratings Services' responses</u>

16. From a general point of view, Ratings Services has put in place a comprehensive range of policies and procedures designed to ensure day-to-day application and observance of the Code of Conduct. These policies and procedures are backed up by training and compliance oversight functions.

We believe that these policies and procedures are working effectively across Ratings Services. Compliance with these policies is essential in preserving Ratings Services' analytical quality and its reputation.

[3] See in particular Appendix III: Default and Transition Experience of Corporates Versus Structured Finance Asset Classes

17. Subject to the same point referred to in the response to Question 2 above, we do not perceive any resulting potential conflicts of interest between the structured finance credit ratings and related services as described above.

Conclusion

We look forward to continuing to discuss these matters of mutual interest with CESR in the coming months.