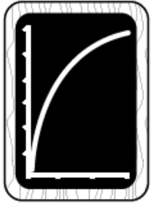

L E A R N I N G C U R V E ®

Recent Developments In The Regulation Of Credit Ratings

After so many highly-rated structured products and other financial investments were drastically marked down following the sub-prime crisis and the ensuing credit crunch, CRAs and their ratings methodologies and practices have come under intense scrutiny. There have therefore been calls in Europe and the U.S. for greater oversight and regulation of CRAs. This Learning Curve considers recent developments in relation to CRAs and, in particular, discusses the key aspects of the new EU framework.

Background

Credit ratings played a key role in the growth of the structured finance market in the late 1990s and 2000s. In addition to the ratings provided for structured finance securities, many transactions contain rating triggers requiring the sale of underlying assets in certain circumstances. It is also common for parties to structured finance transactions, such as swap counterparties and account banks, to be required to maintain a certain minimum rating, failing which such party can be required to provide additional collateral or be replaced by a party having the required rating.

Credit rating agencies and the ratings they provide have been very much in the spotlight during the current financial crisis, not least in view of the large number of structured finance transactions that have been downgraded. Criticisms include the fact that many of the assumptions and methodologies relating to such transactions have been shown to be flawed. Some investors also believe that rating agencies were slow to react to market events, leading to delays in downgrading certain securities and to downgrades of several notches at a time in many cases.

The debate as to how to address these concerns have fallen into two broad categories: first how to better regulate the activities of rating agencies and second how to address concerns that many investors became over-reliant on the credit ratings of the investments they were acquiring and did not undertake adequate analysis and due diligence of the risks underlying such investments.

The IOSCO Code

Until recently, the activities of rating agencies have been largely free of formal regulation. In Dec. 2004, the **International Organisation of Securities Commissions** (IOSCO) published a voluntary Code of Practice in relation to rating agencies which most of the principal rating agencies, including **Standard & Poor's**, **Moody's Investors Service** and **Fitch Ratings**, have subsequently adhered to. The Code sets out standards in relation to various issues including the quality and integrity of the ratings process, independence and management of conflicts and transparency and reporting obligations. As the Code was intended to cover rating agencies' activities across various jurisdictions, it was developed as a set of high level principles rather than detailed rules.

Until this year, the only country that had introduced a significant regulatory framework for rating agencies was the U.S., reflecting the fact that this is where most of the major rating agencies are primarily based. Under the Credit Rating Agency Reform Act 2006, the **Securities and Exchange Commission** has had the power to register and oversee credit rating agencies since 2007. This regulation was intended to be consistent with the principles of the IOSCO Code and not to allow the SEC to interfere in the ratings process.

Following the events of the financial crisis, the IOSCO Code was amended in March 2009 to seek to enhance certain rules relating to conflicts of interest including prohibiting analysts from making recommendations on structuring transactions, differentiating ratings for structured finance transactions and requiring additional disclosure of rating methodologies and historic performance data. In addition, certain changes have been made to the SEC rules including tightening up the rules relating to conflicts of interest and disclosure requirements.

At the G-20 meeting in London in April 2009, an agreement was reached that there should be more effective oversight of the activities of rating agencies and that national authorities should register and oversee rating agencies under standards consistent with the IOSCO Code.

EU Regulation

In the EU, following concerns expressed by **Charlie McCreevy**, the Commissioner for Internal Markets and Services, in July 2008 that the IOSCO Code was a "toothless wonder", an EU regulation has been approved providing for a regulatory framework for credit rating agencies within the EU. This is due to come into effect later this year.

Under the EU regulation, a rating will only be able to be used for regulatory purposes in Europe if issued (or in limited circumstances, endorsed) by a rating agency registered under

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the regulation. The relevant rating agency is required to be incorporated within the EU, meaning that existing rating agencies not located in the EU will need to establish a subsidiary in an EU jurisdiction. There is an exception in relation to credit ratings of entities established outside the EU or securities issued in a non-EU jurisdiction where the ratings will still be permitted to be used in the EU if certain conditions are met. These conditions include requiring the issuing agency to be subject to supervision in its own jurisdiction and the Commission determining the legal and supervisory framework of such country to be equivalent to the requirements of the EU regulation. The rating agency issuing the rating is also required to be certified, which is likely to be a similar process to registration, although some of the requirements can be relaxed in the case of smaller rating agencies.

The EU regulation covers similar ground to the IOSCO Code, setting out detailed rules relating to management and avoidance of conflicts of interest, disclosure of methodologies and ratings assumptions and obligations aimed at improving transparency and disclosure of relevant information. It does, however, prohibit the relevant supervisory authorities from interfering in the ratings process. It also contains specific provisions relevant to structured finance transactions, including increased disclosure obligations, a prohibition on rating agencies making proposals or recommendations in relation to the design of such instruments, and requiring the rating of such products to contain a differentiating marker.

Criticism has included the fact that the EU regulation contains more detailed requirements than the IOSCO Code, particularly in relation to specific provisions relating to internal governance structures and rules relating to individual analysts including requiring a rotation of analysts assigned to particular clients.

An area that remains subject to debate is the "issuer pays" model whereby rating agencies are engaged and paid by the entity whose securities are being rated. Concerns have been raised that this structure involves a conflict of interest. Although the recent de Larosière Report highlighted this as a major issue to be addressed (and the EU Commission is due to report further on this issue by 2012) there does not seem to be a great appetite in the financial markets for the costs to be borne by investors and there may not therefore be obvious alternatives.

Investor Reliance

Addressing the issue of over-reliance on ratings by investors is more difficult but has been highlighted in both the de Larosière report and the Turner review in the U.K. as being a key area that should be addressed. Part of the problem is the extent to which ratings are "hard-wired" into capital requirements set out in the Basel II framework. The de Larosière report recommends that the use of ratings in financial regulations should be significantly reduced over time. The **Financial Services Authority** Discussion Paper published in connection with the Turner review also highlighted concerns as to the extensive integration of ratings into investment mandates and the use of ratings triggers in financial products and contracts. It notes that the use of such provisions can actually contribute to the failure of the counterparty, the very event which they are designed to mitigate. The FSA have for the time being ruled out any specific regulation in relation to such provisions, instead focussing on raising awareness in the investor community of the systemic damage that can be caused by the widespread use of such provisions.

As has been highlighted above, there have already been significant changes that will impact upon the rating agencies and the use of ratings in structured finance transactions. In addition to the changes already introduced and the new regulatory regime within the EU, it is clear that governments and regulators have significant reservations as to the extent to which ratings are embedded within the financial system and this will be an ongoing issue for debate and consultation which may lead to further changes.

This Learning Curve was written by ***Peter Green and Jeremy Jennings Mares****, partners at* ***Morrison & Foerster*** *in London.*

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