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Ms Kim Allen
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28006 Madrid
Spain

ESF/SIFMA RESPONSE TO IOSCO TECHNICAL COMMITTEE CONSULTATION REPORT ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS

Dear Ms Allen

The European Securitisation Forum¹ (ESF) and Securities Industry and Financial Markets Association² (SIFMA) are pleased to respond to the March 2008 IOSCO Technical Committee Consultation Report (CR) on the role of Credit Rating Agencies (CRA) in Structured Finance Markets (SF).

This response reflects preliminary feedback from ESF and SIFMA members in Europe. Please note that as a global organisation, SIFMA is, through a member task force, entering into a broader study of the role of CRAs. The results of that study could change the emphasis of our initial recommendations, which we are providing now so as to not impede the IOSCO process. We will forward a copy of this broader study reflecting the position of SIFMA members globally to IOSCO when it is completed.

We believe that CRAs play a very important role in the capital markets, particularly in SF where they have been critical to increasing the availability of credit and distribution of risk. Nevertheless the recent market turmoil and perceived weaknesses in ratings have given rise to legitimate concerns relating to, inter alia: the rating process, conflicts of interest and transparency.

¹ The ESF is the voice of the securitisation and CDO marketplace in Europe, with the purpose of promoting efficient growth and continued development of securitisation throughout Europe. Its membership is comprised of over 150 institutions involved with all aspects of the securitisation and CDO business, including issuers, investors, arrangers, rating agencies, legal and accounting advisors, stock exchanges, trustees, IT service providers and others. The ESF is affiliated with SIFMA. The ESF has two sister organisations: the American Securitization Forum and the Asia Pacific Securitisation Association.

² SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving an enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in London, New York, Washington DC, and its sister Association, the Asia Securities Industry and Financial Markets Association (ASIFMA), is based in Hong Kong.



Please find attached in Annex 1, our comments on whether the CR correctly analyses the role of CRAs in SF and on the proposed recommendations for modifying the IOSCO Code of Conduct Fundamentals for CRAs (IOSCO Code). Our response is intended to serve as a basis for further discussion with IOSCO and the wider regulatory community and we would welcome the opportunity to do so at your convenience.

Yours sincerely

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ANNEX 1

SIFMA/ESF RESPONSE TO IOSCO TECHNICAL COMMITTEE CONSULTATION REPORT ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS

COMMENTS ON ANALYSIS OF ROLE OF CRAs IN SF

Background to the Task Force Work

Given that CRA related issues are only one of many factors relevant to the market turmoil, we note and support the statement in the CR that the conclusions of the IOSCO CRA Task Force are incorporated in the IOSCO Subprime Task Force. We assume that the CRA Task Force will only finalise its conclusions in light of responses to the CR.

Reliance on CRA Ratings

The text alleges that CRAs do not generally confirm the validity of the underlying data provided to them and that in some cases some CRAs relied on information that prima facie appeared questionable or in the broader context of rapid market changes uncertain or of dubious quality. Irrespective of whether these allegations are true, we would caution IOSCO not to seek a shift in the due diligence obligation from the issuer to the CRAs, which would have significant legal and cost implications for the industry.

We would also suggest more balanced terminology as some of the language used is rather inconsistent: e.g. this section of the CR first talks of SF and particularly CDO investors as appearing to have relied 'heavily' or 'solely' on ratings. This language is later softened to the effect that 'in some cases' credit ratings 'appear' to have taken on greater importance than they might in most other debt markets. To remove the resulting uncertainty we would suggest the use of more consistent terms.

COMMENTS ON PROPOSED RECOMMENDATIONS FOR MODIFYING THE IOSCO CODE

As a general comment, we note and support the retention of the comply or explain provision (Rule 4.1) according to which CRAs may in their own code of conduct deviate from the IOSCO Code providing they explain where and why these deviations exist and how any deviations nonetheless achieve the objectives of the IOSCO Code. We believe that the comply or explain provision provides the necessary flexibility for CRAs.

Recommendation 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.

We agree that the rating review process must be objective and independent of the initial rating process. Although we also agree that this objectivity can be achieved by using separate analytical teams for determining initial ratings and for subsequent monitoring of SF products we are concerned that such separation may undermine consistency and experience throughout the ratings process and ultimately weaken ratings. Mandating the use of separate teams may also challenge the resources of smaller CRAs. On this basis we therefore welcome that the recommended amendment to the IOSCO Code acknowledges that there may be alternatives to separate teams when seeking to ensure the objectivity of the ratings review process.

Recommendation 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.

We support the proposal for CRAs to set up an independent function to review rating methodologies and models and changes thereto. We believe that shortcomings in the assumptions underlying the methodologies and models applied at the time of the initial rating (alongside the rapidly deteriorating performance of underlying assets) to be the major causes of any weaknesses in ratings. To address these shortcomings, we agree that CRAs should internally set up an independent function to regularly review the appropriateness of methodologies and models used in the ratings process.

Recommendation 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.

We agree that CRAs should make all reasonable efforts to ensure that the information used (including information on the underlying assets and borrowers) will support a credible rating. In this context, we would recommend that the meaning of 'reasonable measures' be clarified to help limit uncertainty. As a possible 'reasonable measure' it may be worth exploring whether a CRA should request independent verification of the information provided to it. We also agree that if the rating pertains to a type of SF product with limited historical data upon which to base a rating, the CRA should make clear, in a prominent place, the consequent limitations and uncertainties of the rating. More generally, CRAs can and should do more to communicate on an ongoing basis that their SF ratings comprise only an opinion on the probability of default and/or expected loss based on the application of specific models and methodologies to a limited data set. A rating is not a recommendation to buy or sell the rated product and is not an indicator of market, liquidity or volatility risk.

We would however caution IOSCO not to inadvertently cause a shift of the due diligence responsibility onto CRAs. This would create significant costs and legal uncertainties in the industry. We suggest that the IOSCO Code be more aligned to the recommendation of the Financial Stability Forum requiring CRAs to enhance their review of the quality of the data input and the due diligence carried out by issuers while making it clear that CRAs are not responsible for carrying out the due diligence themselves.



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Recommendation 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.

We support the proposed clarification that human resource quality requirements extend to rating committees to the extent that such bodies are used. In this context we note that HR quality requirements will be supported by the ratings review process.

Recommendation 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.

Recommendation 5 appears to overlap with recommendation 2 to the extent that both envisage the establishment of a review function to (according to recommendation 2) periodically review methodologies and models and changes thereto, and to (according to recommendation 5) review new methodologies as well as the feasibility of providing ratings for new products. We firstly suggest that IOSCO should clarify that the two functions can be combined so that (particularly smaller) CRAs may manage their resources efficiently. The key is that there is a proper review and escalation process in place with senior level sign-off on material changes to existing methodologies and to the CRA taking on innovative structures.

In addition (and contrary to the statement in the CR analysis section that unsolicited ratings of SF products are very rare) recommendation 5 appears to assume that CRAs have the capacity and inclination to carry out unsolicited examinations of new SF products. We suggest that CRAs will deal with new SF products in same way as corporate products – namely that the issuer will approach the CRA who in turn will initiate the process (which may or may not result in a rating) by assigning a lead analyst, with the appropriate vetting/escalation procedure providing additional protections.

Recommendation 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.

As stated in our response to recommendation 2, ratings are only assessments of credit risk based on the application of specific methodologies and models to a specific and limited data set. We believe that any weaknesses in ratings have mainly been caused by shortcomings in the assumptions underlying the methodologies and models applied at the time of the initial rating as well as rapidly deteriorating performance of underlying assets. On this basis, we therefore support the review of methodologies and models when the risk characteristics of the underlying assets change significantly. As a consequence, CRA will need to carry out ongoing analysis of the underlying assets both in terms of the risks represented by the collateral and the borrowers. In cases where complexity of a SF product or insufficient information about the assets underlying it create uncertainty as to the appropriateness of the CRA's existing rating categories, we support the recommendation 6 for CRAs to desist from issuing a rating.



Recommendation 7: A CRA should prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.

We agree that CRA analysts should not provide creative suggestions regarding the design of SF products and support the proposal as an appropriate tool to address potential conflicts of interest. We believe that the recommendation enjoys wide support and understand that some CRAs already have compliance policies in place which prevent analysts from making proposals or recommendations regarding the design of SF products that the CRA rates.

However, we are concerned that the recommendation may be interpreted as prohibiting the inherently iterative SF process and think the recommendation should be clarified to ensure that analysts retain the ability to discuss transactions with issuers and originators so as to make sure they fully understand the structures they are being asked to rate and can provide feedback on rating scenarios. We do not view this feedback as the CRA 'advising' on the deal but rather providing facts about how the methodologies are being applied and how structural changes will affect targeted ratings based on those methodologies.

Recommendation 8: CRAs should ensure that adequate resources are allocated to monitoring and updating its ratings.

We believe that regular monitoring is important and support the steps taken so far by CRAs to increase resources dedicated to the surveillance of SF transactions. We would encourage CRAs to build on these steps and consider greater flexibility in transferring more resources to surveillance when appropriate. In this context we would encourage CRAs to state and adhere to a minimum frequency of ratings review. Investors have indicated that they want more resources devoted to surveillance and would like expanded surveillance information as to how transactions are performing vs. original expectations.

Recommendation 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.

With a view to addressing potential conflicts of interest, we agree that CRAs should set up detailed 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. We would encourage CRAs to explain how those policies and procedures would apply in specific SF scenarios.

Recommendation 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.

With a view to addressing potential conflicts of interest, we agree that CRAs 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 integrity and independence of the CRA's rating process.



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Recommendation 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.

Concentrations of revenue sources for any company are material factors for investors, in so far as they may create a perceived risk that a CRA will be less inclined to use appropriately conservative assumptions in their rating methodologies in order to maintain transaction flow from the client in question. We cannot comment on whether a 10% threshold is the appropriate level for disclosure of concentrations of revenue, but we would encourage the CRAs to develop recommendations for a threshold level at which they disclose material revenue sources. In this context, we would encourage CRAs to consider the implications of interconnected revenue sources that collectively breach threshold levels.

Recommendation 12: A CRA should define what it considers and does not consider to be an ancillary business and why.

We support this recommendation. It is a natural complement to the existing IOSCO Code provision requiring CRAs to separate their credit rating business and analysts from any other business that may present a conflict of interest. In our experience all major CRAs have taken considerable steps to ensure that adequate separation exists between SF credit analysts and ancillary staff and that this separation goes to a more senior management level than used to be the case.

Recommendation 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.

We agree with this proposal. Although there have recently been improvements in the level of communication with the market on this issue, CRAs can and should do more to communicate on an ongoing basis that their SF ratings comprise only an assessment of the probability of default and/or expected loss (depending on the specific CRA) and are not indicators of stability, liquidity and volatility. We recommend that the CRAs develop a succinct summary to be included on the first page of pre-sale reports as to the basis and limitations of their rating and key numerical and quantitative assumptions utilised in the rating development.

Recommendation 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.

We agree that a significant issue facing CRAs from a competitive standpoint is the "race-to-the-bottom" whereby CRAs have a natural commercial incentive to develop rating policies which result in the lowest credit enhancement levels so they win the business over a competing CRA with higher credit enhancement levels. This, however, needs to be balanced against the



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reputational risk to CRAs if rating integrity is compromised. Moreover, not all multiple-enquiry scenarios will necessarily constitute 'ratings-shopping'. Many scenarios can occur where preliminary information might be provided to the CRAs who then provide indicative ratings, which then might not be further pursued by the issuer/arranger for reasons unrelated to the precise CRA feedback. Arrangers and other participants should be able to have a constructive dialogue with a CRA as to what possible credit enhancement levels would be, without incurring costly expenses. We also note that successive CRAs may be presented with different iterations of a proposed SF product and that given such changes this cannot be characterized as ratings shopping.

IOSCO's recommendation may help discourage ratings shopping, although we would recommend that CRAs develop their own thresholds for disclosing where a rating request was made but later withdrawn. In this context we caution that the recommendation may also have unintended consequences, for example, the market may move to a situation where the outliers are never approached to rate transactions in a particular sector or where rating fees become much more success based. An alternative tool against ratings-shopping may be for CRAs to regularly publish and explain the development of their own credit enhancement levels in each product over time.

Recommendation 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.

We support this recommendation.

Recommendation 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.

We support this proposal. Greater disclosure of information such as the base case probability of default or expected losses of the underlying assets of a transaction (and other key figures) when permitted under data protection laws and consistent with CRA confidentiality obligations under the IOSCO Code would provide investors and other market participants more insights on the transactions.

We believe this more detailed analysis and the disclosure of fundamental model criteria is a key to increasing the transparency and understanding of ratings. While much information about ratings models is publically available, there are typically a number of qualitative inputs to models that are not publicly disclosed, yet are tremendously important to the outcome. If a user has access to the underlying information that was used to determine a rating, they are best able to decide whether or not they agree with that rating. It is this separate risk analysis that our members believe would be the most productive avenue to improve transparency. We suggest that at a minimum the following items be covered more extensively in this reporting and analysis: (1) assumptions and methodology used including key quantitative and qualitative criteria; (2) justification of any discrepancy between methodology-implied and actual ratings; and (3) criteria for, and most likely paths to, upgrades or downgrades.

Recommendation 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



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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.

We note that proposal does not mandate the use of a separate set of rating symbols for the rating of SF products. We would not support a new rating scale for SF products, nor do we support a modification of the existing scale or the addition of suffixes. There is some question as to the appropriateness of providing a scoring on other risk factors but we generally believe that trying to finitely score specific risk factors would be confusing to market participants. We also believe that the practical difficulties of implementing such changes to the ratings scale (including e.g. implementing changes to the myriad of references to the current ratings scale in numerous investment guidelines and laws etc) would be significant.

We would instead recommend the separate provision of additional analysis of deal structures and of risk characteristics, as well as the disclosure of the fundamental criteria which underlie the models used to rate securities as the most effective way of improving transparency. In addition we believe that CRA analysts should be prepared to respond to specific questions from market participants as to the rationales for the criteria and assumptions used in the rating models.

Recommendation 18: A CRA should disclose the principal methodology or methodology version in use in determining a rating.

We support this proposal. Whilst methodologies (at least for CDO transactions) are freely available it is sometimes difficult to track which particular methodology has been used to rate a specific issue and whether a rating review has been triggered by a change in that methodology or the performance of the underlying asset pool. To ensure a level playing field across asset classes, we believe that CRAs should highlight clearly to investors which particular methodology a SF rating is based on. CRAs should also be clear as to whether a ratings review has been triggered by a change in methodology or a change in the performance of the underlying asset pools and in both cases the triggering threshold. In this context we would note that methodologies and underlying assumptions/correlations might change as a result of better insights gained from the performance of the underlying asset pools. In the interests of greater transparency, we would also suggest that CRAs disclose their policies on notching.

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.

We support this proposal. While there have been improvements in CRA disclosure we would welcome further enhancements in the accessibility of this information. CRAs can and should make efforts to improve the navigability of their web-sites and make it easier to track changes to methodologies.