Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force

July 2008

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Preamble

The Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force (the Task Force) is a global, investor-led, industry task force formed to examine key issues related to credit ratings and credit rating agencies (CRAs).

The 37-person Task Force is comprised of members drawn from a cross-section of the financial services industry, including asset managers, underwriters, and issuers. It includes senior-level experts in structured finance, corporate bonds, municipal bonds, and risk. The Task Force is also global, with members from the US, Europe, and Asia.[1] In addition to providing industry input to lawmakers and regulators in Europe and Asia, the Task Force has been designated by the U.S. President's Working Group on Financial Markets (the PWG) as the private-sector group to provide the PWG with industry recommendations on credit rating matters.

To determine priority areas of focus, the Task Force first sought to identify what—in the view of its industry experts—were the credit-rating-related causal variables that played a significant role in triggering the current crisis. Sixteen key issues were identified, and then stack-ranked in order of importance by the Task Force members. Those issues that headed the list are the issues that the Task Force has addressed in its below recommendations.[2]

The Task Force engaged in discussions with, and solicited input from, a number of lawmakers, regulators, and CRAs across the globe. The below recommendations have been crafted with the dual goals of: a) avoiding a repetition of the credit-rating-related turmoil of the past year; and b) strengthening the investor confidence that is vital to robust and liquid global financial markets.

The Task Force recognizes the important role played by CRAs and the ratings they provide in the overall functioning of our financial markets. In light of recent market turmoil, however, particularly in markets relating to residential mortgage-backed securities (RMBS) collateralized by subprime mortgages and collateralized debt obligations (CDOs), questions have arisen regarding the quality of CRA ratings and the integrity of the rating process. The resulting decline in investor confidence has been a key factor among those that have led to investor reluctance to invest in RMBS and CDOs, and to liquidity issues generally in our global markets.

The Task Force believes that if the recommendations are followed, we will enhance the ability of market participants to understand credit ratings and to incorporate ratings properly into their own independent risk assessments. While some of the recommendations relate to issues particular to the rating of structured products, the recommendations often apply to the ratings process generally.

1 *A roster of Task Force members can be found in Appendix A.*

2 *A summary of the stack-ranking results can be found at http://www.sifma.org/capital_markets/cra-taskforce-issues.shtml*

The recommendations include the following:

- *CRAs should provide enhanced, clear, concise, and standardized disclosure of CRA rating methodologies (*see *p. 3);*
- *CRAs should disclose results of due diligence and examination of underlying asset data examinations, and limitations on available data, as well as certain other information relied upon by the CRAs in the ratings process (*see *p. 5);*
- *CRAs should provide disclosure of CRA surveillance procedures; this will foster transparency, and allow market users of ratings to understand their bases and limitations (*see *p. 8);*
- *CRAs should provide access to data regarding CRA performance; this will allow investors to assess how CRAs differ both in the performance of their initial ratings, and in their ongoing surveillance of existing ratings (*see *p. 9);*
- *Conflicts of interest should be addressed with a sensitivity towards the difference between "core" CRA services and CRA consulting and advisory services (*see *p. 10);*
- *A global SIFMA advisory board of industry participants should be established to advise regulators and lawmakers on ratings issues; this will give regulators access to industry expertise, and encourage the more fully harmonized global regulatory framework the Task Force views as essential (*see *p. 11);*
- *Lawmakers, regulators, and law enforcers across the globe should coordinate more closely in addressing this global problem, in order to avoid counter-productive, piecemeal, inconsistent attempts at remediation (*see *p. 12);*
- *CRA fee structures, and identities of top payors, should be disclosed by CRAs to their regulators (*see *p. 12);*
- *CRAs should ensure that ratings performance of structured products is consistently in line with ratings performance of other asset classes; this will increase investor confidence in the reliability of ratings (*see *p. 13);*
- *Rating "modifiers" should not be the means adopted to create transparency; they would lead to significant unnecessary costs, while at the same time likely triggering unintended negative consequences (*see *p. 14);*
- *Investors should understand the limits of ratings, and use them as just one of many inputs and considerations as they conduct their own independent analyses (*see *p. 16); and*
- *All members of the financial industry involved in the generation and use of ratings, including issuers and underwriters, should examine their processes with an eye towards improvement, including working towards standardizing reporting and disclosure on underlying assets (*see *p. 17).*

1. Enhanced Disclosure of CRA Rating Methodologies

Ratings of structured securities have been a particular source of controversy during the past year's market turmoil. The Task Force found that ratings of structured securities were generally based largely on CRA statistical models that predicted future performance of the assets that collateralized the rated securities, based on the past performance of apparently similar assets.

The Task Force determined that these quantitative, model-driven analyses assisted arrangers, underwriters, and securitization issuers by facilitating pricing consistency and predictability between the primary/origination market and the secondary/securitization market. Certain models, particularly many relating to RMBS, proved to be based on overly optimistic assumptions about asset performance, however. This was likely due to their reliance on a data set of past performance that looked back only to the relatively recent years for which performance data was available, without sufficiently accounting for the possibility of shifts in the economy and significantly changed market conditions, and which analogized the future performance of new assets to past assets, without sufficiently accounting for qualitative differences between the assets.

The Task Force found that CRAs publish general descriptions of their structured security rating methodologies, and in some instances license their statistical models to paying subscribers. The Task Force determined, however, that even when CRAs licensed these models, this information was generally insufficient for investors to understand CRA rating methodology with respect to particular structured securities. For example, even if an investor licensed the CRAs' models and obtained all the data inputs to run the model for a particular security, the investor still could not determine what assumptions and adjustments the CRAs employed in determining their final assigned rating. Therefore, investors generally did not understand the method by which CRAs determined ratings for particular structured securities, could not on their own determine any potential flaws in the CRAs' analyses, and were unable to monitor the performance of the securities (some of which proved to be more susceptible to ratings volatility than traditional rated corporate debt) in comparison to the assumptions underlying the CRAs' ratings.

The Task Force finds that, prior to the recent subprime mortgage crisis, investors were generally not sufficiently aware of the particular limitations associated with the CRAs' statistical models, when the CRAs deviated from those models in rating securities (particularly structured products), the key assumptions underlying those ratings, and the potential impact of changes in such assumptions.

The Task Force recognizes that ratings are not solely model-driven, and that other factors impact ratings. Models are, however, clearly an integral part of the ratings process.

The Task Force believes that this limited transparency in the ratings process, and the resulting inability of the market to understand clearly the bases of ratings of certain structured products, were primary causes of misunderstandings of the ratings. These misunderstandings, in turn, were central to the ratings-related market turmoil of the past year.

The Task Force finds that greater disclosure by CRAs with regard to aspects of the rating process, including statistical models, would enhance transparency in the structured products market by providing market participants with greater understanding of the ratings analysis.

The Task Force therefore recommends that CRAs provide greater disclosure with regard to the method by which they determine ratings for securities, and mortgage- and asset-backed structured securities in particular. This will enable investors to better understand and evaluate the CRA analysis, and monitor the performance of the rated securities in comparison to the rating analysis over time.

The Task Force concluded that it would be preferable for CRAs to adopt the practice of providing clear and concise disclosure, preferably in the form of a "pre-sale report," rather than disclose additional large quantities of raw information pertaining to the model. This disclosure, above and beyond current practice and sufficient to enable the market to understand what a rating means and how it was derived, should include:

a. A description of the CRA model and model outputs (including cumulative collateral loss assumptions and assumptions relative to the pre-securitized assets and loss curve over time, timing of losses, default frequency and severity expectations, the amount of loss coverage required at each rating level, and credit enhancement requirements);

b. Inasmuch as ratings are not purely model-driven, and deviations from the model are common, a description of any material deviations from the rating or credit enhancement analysis called for by the CRA model, any material adjustments to the model for the purpose of the subject rating, and the reasons for such deviations/adjustments;

c. A description of qualitative factors relied upon by the CRA in its analysis; and

d. A description of the key risks and sensitivities of the rating to key variables (as well as compensating factors) considered by the CRA in determining its rating, such as external changes that could cause a rating to change (*e.g.*, a decline in home prices), including any stress test results.

Each rating should be developed from a general model or criteria that have been published by the CRA. To the extent that general model information is already published by a CRA, the CRA should, in its pre-sale report for a rated security or in such other place as is reasonable, reference such information and indicate where this information can be found.

The provision of this kind of additional specific information by CRAs could be used by investors for investment decision analytics and for enhanced, better-informed risk control decisions. In addition, such greater disclosure would highlight the key distinctions between, and different risk characteristics of, certain structured products and corporate bonds. This additional transparency would at the same time obviate the need for rating "modifiers" to distinguish between broad categories of issue types.

While this disclosure should be appropriately concise, a level of helpful detail is called for. Simply sharing numerical scores that weigh and aggregate information, such as "volatility scores" or "stress test scores," would by itself be of limited use to investors conducting their own risk analyses.

In order to ensure the provision of this information on a clear and comparable basis, the Task Force recommends that CRAs consider developing guidelines for pre-sale reports that would encompass the disclosures recommended in (a)-(d) above, and that would appropriately reflect of the differences among different types of securities. These guidelines would serve as a framework for disclosure, without mandating a strict homogeneity across the CRAs to the detriment of each CRA's unique methodologies.

This increased transparency, adopted as a permanent ongoing practice of the CRAs, would enhance the ability of investors and other market participants to understand and use a rating as just one of many inputs and considerations in their own independent risk analyses, with a clear understanding of the basis and limitations of the rating.

2. Enhanced Disclosure of Due Diligence Information, and Other Information Relied upon by CRAs in the Rating Process

A. Disclosure of Due Diligence/Reviews of Data Accuracy. The Task Force finds that CRAs have in recent periods generally performed only limited (and, in some instances, did not perform any) independent review or due diligence to confirm the accuracy of data provided to them in connection with the assets underlying structured securities, and performed limited independent confirmation of asset origination standards. Instead, perhaps in part because some CRAs have not seen it as their role to do more, they have substantially relied on publicly available information and/or the representations of other parties to the transaction with regard to the reliability of the data presented to the CRAs.

The post-mortems of the recent subprime mortgage crisis suggests that this reliance by CRAs on other parties to verify the quality of assets underlying certain structured securities being rated by the CRAs, which was combined with only a limited understanding by some market participants as to the level of this reliance, may have led to ratings that were inaccurate reflections of the default risk of such structured securities (for example, some such ratings neglected to take into account the higher incidence of mortgage fraud). In addition, there are indications that some CRAs at times relied on information that may have been questionable or suspect on its face, taking into account market changes at the time.

The Task Force therefore recommends that CRAs disclose in their pre-sale reports, at a minimum:

a. Whether and to what extent the CRA has conducted or reviewed any independent examination and/or review to confirm the accuracy of underlying data and asset origination standards relating to a security;

b. If the CRA relied on the due diligence or examination of another (such as an issuer, underwriter, or third party) with respect to the rating of a security: who conducted the due diligence or examination, what their relation is to the transaction, and the extent to which such due diligence or examination was relied upon;

c. What the due diligence analysis entailed (*e.g.*, data accuracy, origination standards and processes, loan level due diligence, credit, or value);

d. With regard to asset-backed securities, what due diligence was conducted on the individual securities or assets in the collateral pool underlying the structured deal, and what if any individual components did not receive any due diligence review; and

e. The results of the due diligence review, including the exceptions that were noted.

If a CRA does not undertake an independent examination of the underlying data and asset origination standards, the Task Force believes the CRA should satisfy itself that some reasonable minimum level of examination has been undertaken by other parties to the transaction to ensure that the information underlying each CRA rating and opinion is of sufficient quality to support a credible rating. For example, CRAs should question issuers to satisfy themselves that thorough underwriting due diligence, including data verification, has been performed by reputable parties.

Where the diligence disclosure reflects that a given security has a limited amount of historical data upon which to base a rating, as may be the case with newer structured finance securities, the CRA should prominently disclose the limitations on available data and the resulting rating's limitations and augmented risks. The Task Force anticipates that such limitations would be reflected in higher credit enhancement requirements.

The Task Force does not, however, recommend a blanket prohibition on the issuance of a rating on a structured product where there is limited information available on the underlying assets. In the instance of new structured products, for example, there may be little or no historical information relating to the underlying assets, but the underlying assets may be comparable to, or a variation on, assets previously incorporated into structured products as to which there is an adequate amount of data available. A broad prohibition on the ability of CRAs to rate new kinds of issues would stifle innovation, both in the creation of new kinds of issues and in the ratings process. To ensure transparency of the unique considerations and risks related to the rating of a new kind of security, the Task Force recommends that CRAs prominently and with an appropriate level of detail disclose: (i) that there is limited information available regarding the assets underlying the security being rated; (ii) the methodology used by the CRA to rate the new structured product in the absence of extensive information; and (iii) the attendant risks involved.

This disclosure would not only provide additional information to investors regarding the level of examination underlying a given rating, but also serve as an impetus to CRAs to make substantive improvements to their examination processes.

B. Disclosure of Other Information Relied upon by the CRA in the Rating Process. The SEC has suggested disclosure of not only the due diligence and model information described above, which the Task Force views as the most important disclosure, but also of all other information used by a CRA to determine credit ratings of structured finance issues. This could, for example, include asset tapes representing the composition of the asset pool, representations and warranties provided by the securitization sponsor, originator, or seller, and selection criteria for asset pools.

The Task Force recognizes that, as the SEC suggests, this disclosure may also enable CRAs to provide "unsolicited" ratings by CRAs that were not engaged to rate the issues. The primary goal of the SEC in making this proposal is to promote greater competition among CRAs.

If such disclosures can be made in a manner that is sensitive to the following important issues, the Task Force recognizes that this further disclosure and enhanced transparency may be beneficial. One important issue is that some information is proprietary and/or confidential (*e.g.*, information regarding underlying obligors in the context of asset-backed commercial paper); and limitations on the ability to disclose such information would have to be addressed. Also, it is important that such disclosure requirement not chill appropriate business communications (for example, by requiring that all oral communications between an issuer and CRA be reflected in writing) or stifle innovation. In addition, the Task Force's view is that such disclosure should not serve to expand the liability of an issuer or underwriter.

Finally, the Task Force cautions that if unsolicited ratings are published, they should be published in a manner that makes quite clear to the market the unsolicited nature of the ratings. That is because unsolicited ratings will necessarily be issued on the basis of less information, and lack the robust iterative communications with the issuer's management and onsite visits that attend solicited ratings. Investors should therefore be made aware of the unsolicited nature of the ratings, so that they can properly consider the weight that they wish to give such ratings.

C. Comprehensive Disclosure; CRAs Best-Positioned to be Comprehensive Disclosing Party. The Task Force strongly supports enhanced ratings transparency, and views it as essential to restoring confidence in ratings and their quality.

As to the question of who should disclose due diligence and examination information, and other information, that the CRA relied upon in issuing its rating, the Task Force recognizes that there are various views. The Task Force understands that a number of the CRAs are of the view that they should not be the parties tasked with disclosing such information. Rather, they suggest, others, as the "owners" of much of the information, should take on that responsibility.

The Task Force believes, however, that the CRA is the party best suited to disclose the due diligence and examination information that the CRA used in issuing its rating. This is for three primary reasons. First, the CRA is the party that actually relied upon the information, and determined that the information was both used by the CRA in arriving at its rating and of sufficient quality to support the CRA's rating. Second, the CRA's view as to what information is necessary to determine an initial credit rating or to maintain surveillance on an existing credit rating can be applied in a consistent manner by the CRA across various issues rated by the CRA. Finally, while such information may come from multiple sources (including the issuer, underwriter, sponsor, depositor, and trustee), the CRA is the centrally situated repository of all information relied upon by the CRA (in the formation of its opinion leading to the CRA's rating), and therefore uniquely situated to provide "one-stop-shopping" and disclose the information most efficiently.

3. Disclosure of CRA Surveillance Procedures

The Task Force finds that more timely and diligent CRA surveillance of rated structured securities would decrease the incidence of significant delays between deteriorating asset performance and related ratings downgrades, alleviate uncertainty regarding potentially impending downgrades, and contribute to stabilization of the credit markets. Uncertainty regarding the continued accuracy and reliability of ratings of certain structured securities has, the Task Force believes, been a primary factor leading to investors' increased reluctance to invest in structured securities. This, in turn, has exacerbated the recent liquidity crunch experienced by the markets.

The Task Force therefore recommends that CRAs disclose in their pre-sale reports how a rating will be handled on a going-forward basis following issuance of the rating, and the nature and extent of surveillance that will be performed by the CRAs to ensure that the rating remains current and reliable. CRAs should also regularly disclose when this process has been completed with regard to individual transactions and ratings. The Task Force anticipates that this increased disclosure will incentivize CRAs to implement improved targeted procedures, and allocate sufficient resources to surveillance of existing ratings.

This disclosure should at a minimum include:

a. How frequently the CRA will review the rated security (*e.g.*, on a certain periodic or event-driven basis), and how often the rating will be updated, if the circumstances warrant an update;

b. Whether the timing and nature of a surveillance review will depend on external factors (*e.g.*, the frequency and quality of updated data received from the issuer or servicer of the security);

c. How soon after the CRA receives updated data it will review the data and, if appropriate, act upon the new information by updating or confirming a rating;

d. The extent of the surveillance review (*e.g.*, review of a particular security, a particular sector, or, type of transaction);

e. What the surveillance review will entail (*e.g.*, a quarterly assessment comparison of security performance to initial collateral loss expectations and assumptions; periodic or event-driven sector analyses);

f. If the issue is a structured finance security, whether its rating will be periodically updated based on a re-analysis of the underlying assets or securities; if so, how often this re-analysis will be conducted; and how this will affect the surveillance of the structured finance security;

g. Whether the team or analyst conducting the surveillance is different from the party who was involved in assigning the initial rating, and if so why;

h. Whether different models are used for rating surveillance than for initial ratings, and whether changes made to rating models and methodologies, including their criteria and assumptions, are retroactively applied to existing ratings; and

i. The status of current surveillance for each rating.

Surveillance should be conducted with sufficient frequency to allow market participants to take into account on a real-time basis the underlying market changes and issue- or issuer-specific events having an effect on rated securities. This ongoing analytical process should also work to incorporate qualitative marketplace factors into the ratings (*e.g.*, shifts in the housing market).

In instances in which the frequency and quality of surveillance is dependent on information received from issuers of securities, or servicers of the assets underlying such securities, CRAs should disclose that they lack the information necessary to update a rating, or may not be able to update a rating in a timely fashion. Similarly, if the frequency and quality of surveillance for the rating of a CDO or RMBS depends on the CRA's re-analysis of the underlying assets or updating of the rating of the underlying ABS, the CRA should disclose this factor and describe in detail the potential effects and delays on surveillance of the structured product.

The Task Force believes that increased surveillance, and investor awareness of the nature and extent of the surveillance being conducted, is central to investor confidence in the reliability of ratings over time.

4. Disclosure of Comparable CRA Performance

The Task Force finds that CRAs have not routinely published historical performance data regarding their ratings that is easily verifiable and comparable. Consequently, performance data that has been disclosed has been of limited utility to market participants seeking to compare the performance of different CRAs.

The Task Force recommends that CRAs publish verifiable, quantifiable historical information about the performance of their ratings in a format that facilitates the ability of investors and others to compare the performance of different CRAs directly. The Task Force has encouraged the CRAs to contribute their thoughts and suggestions for specific common performance metrics. For example, one such potential performance metric for structured products might be a comparison of the collateral loss curve used to determine an initial rating, and the actual performance of the collateral over time for the relevant sector. The global Credit Ratings Advisory Board described below may facilitate the creation of such a common metric, thereby promoting competition and superior performance.

Specifically, CRAs should disclose a minimum level of transparent historical ratings migration and default performance by asset class on a directly comparable basis (*i.e.*, a common approach regarding cohort treatment, treatment of withdrawn ratings, and structured finance sector definitions, etc.).

The common performance metrics chosen should not interfere with the unique rating process of each individual CRA. They should, however, encourage increased surveillance by the CRAs and allow for ease of comparability by investors and other market participants.

5. Differentiation between CRA Core Services and CRA Consulting Services

The Task Force finds that there is a perception by some that the degree and nature of interaction between CRAs and issuers during the ratings process may result in conflicts of interest. This perception undermines investor confidence in the accuracy and reliability of ratings. These perceived conflicts can arise both from the interaction between CRAs and issuers in the course of a CRA assigning a rating to a particular security, and from the CRAs' provision of consulting or advisory services.

The Task Force notes that each of five major CRAs (A.M. Best, DBRS, Fitch, Moody's, and Standard & Poor's) committed in their Joint Response to the IOSCO Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets to "plainly indicate" that it does "not and will not provide consulting or advisory services to the issuers the [CRA] rates."

In order to provide clarity to market participants, the Task Force recommends that "core" rating services be clearly defined by the CRAs and distinguished from such "consulting or advisory" services. The Task Force further recommends that CRAs clarify that "consulting or advisory" services exclude other "ancillary" services provided to issuers and intermediaries in the ordinary course of business.

The Task Force views the CRAs' permissible "core" services as including:

a. the assignment and monitoring of public, private, and private placement ratings;

b. issuance of credit estimates and hypothetical ratings, including requested Rating Evaluation Service and Rating Advisory Service (RES/RAS) services regarding issuer-proposed structures of hypothetical securities, indicative, or preliminary ratings, and impact assessments;

c. hybrid securities assessment services;

d. internal assessments;

e. ratings coverage of project and infrastructure finance transactions and hybrid securities;

f. dissemination of press releases and rating reports (that include the rating opinion);

g. research reports and other publications, including methodologies, models, newsletters, commentaries, and industry studies;

h. regular oral and written dialogue with issuers, intermediaries, investors, sponsors, regulators, legislators, trade organizations, and the media; and

i. conducting and participating in conferences, speaking engagements, and educational seminars.

In particular, the Task Force believes that these "core" services include the iterative process that occurs between an issuer, arranger, underwriter, and CRA during the rating of structured finance, project and infrastructure finance, and hybrid securities.

The Task Force believes there is a misperception by some that this type of "core" interaction is essentially a consultation service by CRAs that gives rise to an insuperable conflict of interest, and which undermines the integrity and reliability of the resulting rating. As described above, however, the process of rating structured finance, project and infrastructure finance, and hybrid securities necessarily involves an iterative give-and-take between the issuer, arranger, underwriter, and CRA as part of the "core" services performed by the CRA.

In light of this, the Task Force does not recommend placing limitations on this iterative process. Rather, the Task Force recommends that CRAs maintain an adequate governance structure that includes policies, procedures, mechanisms, and firewalls designed to minimize the likelihood that conflicts of interest will arise, and to manage the conflicts of interest that do arise.

Similarly, "ancillary" services, in the view of the Task Force, are permissible rating-related services that are generally segregated by the CRA into separate business groups. The Task Force views examples of "ancillary" services as including, among others, market implied ratings (MIRS), KMV credit risk management, data services, credit risk solutions, and indices.

6. Creation of SIFMA Global Credit Ratings Advisory Board

The Task Force finds that there is a need for market participants globally to, in a direct, impactful, and coordinated fashion, provide expert input and advice on issues related to credit ratings to relevant regulators, lawmakers, and market participants globally. This would foster a globally consistent and convergent approach to ratings issues.

The Task Force therefore recommends the creation of a global, independent, industry Credit Ratings Advisory Board, under the auspices of SIFMA.

The Advisory Board would perform strictly advisory functions, and serve as a consultative resource. The Advisory Board would not engage in any regulatory oversight of CRAs. Furthermore, the Advisory Board would not have any regulatory, quasi-regulatory, judiciary, enforcement, or auditing powers.

The Advisory Board would be composed of a broad representation of investors, underwriters, and issuers. Inasmuch as the Advisory Board would largely be continuing the efforts of this Task Force, the initial Advisory Board members would be drawn primarily from the membership of the SIFMA CRA Task Force. In performing its activities, the Advisory Board would confer with the CRAs from time to time.

More specifically, the Advisory Board would:

a. Serve as a resource on issues relating to credit ratings, both by: (i) identifying and exploring potential issues; and (ii) advising, providing informed input to, and responding to specific requests for expert consultation from regulators (such as the European Commission, the SEC, and IOSCO), lawmakers, and market participants;

b. Facilitate the global convergence of regulatory approaches by seeking regular dialogue with local, national, and global regulatory and lawmaking bodies working in this area;

c. Promote the development of objective performance criteria, guidelines, and best practices for CRAs across a spectrum of areas, including CRA rating performance, surveillance, disclosure, and transparency; and

d. Disclose on a public website, and through other public media, CRA performance information made available to the Advisory Board by the CRAs themselves and by governmental bodies, though the Advisory Board would not itself make any independent performance assessments.

7. Convergent Global Regulatory Framework

The Task Force is highly sensitive to the fact that the credit rating issues are global in nature. The Task Force believes, therefore, that it is essential that solutions to the issues raised by ratings be globally coordinated to a greater extent than is the case today. This is necessary for the solutions to be effective, and also to avoid adverse complications that can otherwise be caused by the application of inconsistent prescriptive solutions.

The Task Force therefore recommends that all governmental and regulatory bodies that contemplate addressing the roles and activities of CRAs, and the issues that arise from the credit ratings CRAs publish, recognize and act in accordance with the need for a more fully harmonized and convergent global regulatory framework. Our goal is to avoid piecemeal, fragmented, non-coordinated regulatory or other remedial actions.

A more fully harmonized, convergent global approach is particularly essential in the instance of laws, regulations, best practices, and settlement agreements and other legal requirements that set forth responsibilities and divisions of responsibilities among CRAs, investors, issuers, underwriters, and others, in order to maintain an orderly, transparent, properly functioning global financial marketplace.

8. Disclosure of CRA Fees

The Task Force finds that there is a perception among some that an inherent conflict of interest exists in the credit rating process because many CRAs receive the majority of their revenue from the issuers they rate. This perception is particularly acute in the structured finance area, given that in recent years an increasing amount of the CRAs' revenue stream has been related to structured finance ratings. This, it is suggested, increases the incentive of CRAs to maintain the transaction flow leading to this revenue. With regard to complex structured finance transactions, concerns have been voiced about client dependency and the risk that CRAs may overrate structured products to ensure continued client relationships.

The Task Force therefore recommends that CRAs be required to submit disclosure regarding their fee structures to the applicable regulators for review of the overall fees received by each CRA from issuers, investors, and other parties in the ratings process. The Task Force also recommends that CRAs disclose to

the applicable regulators on an annual basis: (a) the percent of fees each CRA receives from issuers versus investors; (b) fees by sector; and (c) the identities of the payors of the largest fees that the CRA has received (on both a sector and a total basis).

The Task Force further recommends that CRAs and issuers of structured securities agree that rating fees associated with surveillance be paid to CRAs directly from the related transaction structures on a periodic basis, in order to align the rating fee structure and timing with the timing of the services the market understands to be, and desires to be, provided. The Task Force recognizes that this may have to be addressed differently in situations in which surveillance fees are not deal-specific, as in revolving master trusts.

As to a related issue, that of who pays the fees to the CRAs, the Task Force recognizes that in today's marketplace CRA services are offered based on both investor-pay and issuer-pay models, and that this affords market participants the ability to choose freely whichever model they prefer.

9. Consistent Ratings

The Task Force finds that the confidence of market participants in ratings of structured products has been undermined in part by the recent pace, precipitousness, and extent of rating downgrades of certain structured products (primarily subprime RMBS, and CDOs backed by subprime RMBS), and by the inconsistency between these rating migration levels and the migration levels of other classes of structured securities and other asset classes, such as standard corporate bonds. The Task Force believes that each rating symbol should be clearly defined and consistently applied for all types of products to which that symbol is assigned.

In order to obtain this consistency, the Task Force recommends that each CRA undertake a review of its ratings process with regard to structured products to ensure that going forward the ratings performance of structured products will be consistently in line with the ratings performance of ratings in other asset classes. This would include consistency in the projected probability of default and/or expected loss for a given rating category, depending on the policy of the respective CRA. In certain cases, if permissible under off-balance sheet rules and regulatory recourse rules, this may mean that credit enhancement levels on certain structured products may need to be raised in order to reduce differences in potential ratings volatility between various structured products and corporate issues of the same ratings category.

While the Task Force does not believe that blunt "volatility" ratings by themselves would enhance clarity as to the nature of the risks associated with particular issues, the Task Force is supportive of CRAs enhancing transparency by disclosing in pre-sale reports information regarding the historical performance, data adequacy, complexity, and market value and change in loss rate (on the collateral backing a pool) sensitivity of a transaction, governance, and sensitivity to change in the expected loss rate on the collateral that might in turn impact the volatility of a particular issue. Similarly, the Task Force does not believe that summary "stress testing" scores would by themselves increase transparency, but the Task Force is supportive of disclosure with regard to the results of stress test "what if" analyses on structured products issues.

This recommendation dovetails with the increased disclosure and transparency recommendations included herein, in that both are intended to restore investor confidence in the reliability of structured product ratings and increase the level of investor understanding of the meaning and appropriate use of these ratings.

10. Rating Modifiers

Certain regulators and organizations, including IOSCO and the SEC, have recently raised the possibility of appending a suffix or credit rating "modifier" to ratings of certain issues, such as structured finance issues, to better identify the nature of those issues. Thus, a "AAA" structured finance issue would now be designated "AAA.SF." The goal, as we understand it, is greater transparency.

The Task Force strongly supports enhanced transparency and disclosure, but suggests that the transparency goal here can be best met instead by adoption of the transparency recommendations that the Task Force proposes elsewhere in these recommendations.

The Task Force is concerned that this proposed change could further damage our already unsettled capital markets, impair capital raising (for student loans, auto loans, credit cards, mortgages, and the like), and lead to the sudden sale of structured finance securities at fire-sale prices, into an already highly illiquid market, at a time when our financial markets can ill afford such an unnecessary shock to their system. The Task Force recommends therefore that CRAs not use ratings modifiers, but instead provide greater transparency and disclosure regarding the models, inputs, and assumptions underlying any given rating, as described elsewhere in these recommendations.

The Task Force believes that the use of credit rating modifiers to distinguish structured finance securities would at best be a cosmetic solution to the credit rating problems. Given that most investors in structured finance issues are highly sophisticated Qualified Institutional Buyers, with $100 million or more of assets under management, they are unlikely to gain any new information from an appended "SF."

In addition, the Task Force believes that this proposal could have several negative unintended consequences.

First, the existing rating categories are embedded in investment guidelines for asset managers. Under the modifier approach, those same "AAA" securities would now be referred to by a new symbol (*e.g.*, AAA.SF) that does not explicitly appear in any existing guidelines.

The addition of a modifier to existing ratings might force asset managers working within existing carefully worded investment guidelines that mandate that purchases consist of particularly rated securities, such as "AAA" securities, to sell off structured finance securities now rated under a new symbol into an already illiquid market (depending, of course, on the specific wording of the guidelines). It may well also restrict future purchases of such securities, while the asset manager undertakes a lengthy guideline-revision process.

This problem is not restricted to investment guidelines. Asset managers and other parties would face also considerable difficulties given what the Task Force believes are easily tens of thousands of laws, regulations, corporate documents, and bilateral contracts embedded with existing rating symbols. They include state insurance and other regulations, pension legislation, SEC rules, ERISA, Basel II, compliance programs, board of directors minutes, and other US and non-US laws and regulations.

The time it can take to change even State laws in the 50 States of the US is considerable. For example, while the investor-protection Uniform Securities Act has enjoyed widespread consensus support by the National Conference of Commissioners on Uniform State Laws and others, only 14 of the States in the US have adopted it since it was introduced 6 years ago. Similarly, it took the better part of a decade for all 50 of the States in the US to adopt the broadly supported revisions to Article 8 of the Uniform Commercial Code. In light of this, it is unlikely that this problem would be addressed during even a reasonably lengthy "burn-in" period for implementation of the modifier proposal, if the proposal were adopted.

Second, attaching a modifier to all structured products ratings might lead to the impairment of structured products that have thus far performed well and avoided the precipitous rating downgrades experienced by sub-prime RMBS and CDOs of asset-backed securities, such as credit card, auto loan, and prime mortgage asset-backed debt. By applying a blanket modifier to securities with a variety of types of underlying collateral, the proposal would hinder the ability of investors to differentiate between such structured finance securities, and might even increase the possibility that investment boards of institutions such as pension plans and foundations might group these types of securities together as "problem" securities, and react by instituting a blanket policy to not own any securities with an SF modifier. The result could be a substantial reduction in liquidity for credit card, auto loan, prime mortgage, and other asset-backed debt–resulting in higher borrowing rates to consumers.

Third, the modifier proposal raises systems and cost issues. Financial firms rely on extensive compliance and other systems that have been set up to handle the existing ratings. The firms' computer fields can accommodate the current ratings. Firms involved in securities issuance, underwriting, investment, and custody may, however, not have systems capable of accepting and interpreting the new ratings that are being considered, with fields wide enough to handle the extra characters that such a new, expanded rating scheme would require. Similar major industry systems concerns, such as Y2K systems disruptions, have of course been averted, but only at considerable expense.

To quantify the cost of the modifier proposal, in terms of the otherwise unnecessary refitting of current systems that implementation of the proposal would require, SIFMA polled industry firms of various sizes. SIFMA found that the cost to engage in such refitting to avoid systems disruptions would be significant, and in a number of instances would be millions of dollars per financial firm.

Given that there is little benefit to be realized from this proposal, and that we can anticipate significant negative consequences and needless costs, the Task Force strongly suggests that the modifier proposal not be adopted – even in the alternative.

11. Independent Risk Analysis by Investors

The Task Force recognizes that as we have seen increased complexity in structured finance products, and ever-increasing embedded regulatory dependence on ratings, certain investors have come to rely on credit ratings to the detriment of a more complete independent risk analysis. The complexity of structured products, due to complex legal structures and financial devices, and the multitude of individual underlying assets for which little or no information is publicly available, creates great difficulties for investors seeking to analyze risk. This, in turn, encourages increased reliance on the ratings of CRAs. This increased reliance on CRAs' ratings, to the detriment of investors' own valuations, risk analyses, and continuing review of structured products, has resulted in credit ratings having an inordinate impact on the valuation and liquidity of, in particular, RMBSs and CDOs of ABS.

The Task Force believes that market participants should understand and use credit ratings as just one of many inputs and considerations in their own independent risk analyses of different classes of instruments. Investors should augment their use of CRA risk assessments by conducting their own analysis of the risks involved. As discussed elsewhere in these recommendations, the Task Force believes that investors would be best aided in performing such analysis by the provision of additional transparency in the credit rating process, the data review and due diligence conducted in the ratings process, and the surveillance procedures undertaken by CRAs to foster a better understanding of and scrutiny of the basis of the ratings.

In addition, to encourage investors to conduct an independent determination of security credit quality, the Task Force recommends that CRAs prominently disclose and emphasize on each rating pre-sale report that: (a) a credit rating is a CRA's opinion of the loss characteristics of a given security, not a seal of approval or a recommendation to buy, sell, or hold a given security; (b) investors should read the entire report issued with a rating as one element of their own risk assessment process; and (c) investors should not rely solely on the credit rating itself.

Also, CRAs should assist investors in developing a greater understanding of the nature and limitations of a credit rating in particular asset classes. The Task Force believes investor education by CRAs is integral to preventing investor over-reliance on ratings.

Although the Task Force recognizes that the use of credit ratings embedded in regulation may foster reliance on ratings, the Task Force has not found that this suggests that we should delete all references to, and use of, credit ratings in regulation. The incorporation of credit ratings in securities regulation in many cases continues to provide an appropriate minimum, though not sufficient, threshold, and is an important data point that should be part of a larger analysis. The Task Force believes that investor over-reliance is less a regulatory issue, and more one of best practices within the marketplace.

12. Disclosure by Issuers & Underwriters

The Task Force believes that it is important for all members of the financial industry involved in the generation or use of ratings, including not only CRAs and investors – but also issuers and underwriters – to examine what measures they can take to improve their processes so as to enhance ratings and the proper understanding and use of ratings.

The Task Force recommends that issuers and underwriters work towards improving transparency and disclosure with regard to structured finance issues by standardizing reporting and disclosure on underlying assets. At the same time, the Task Force recognizes that it is important to be sensitive to the differences between private and public issues, and to the fact that information may at times be proprietary or confidential.

The Task Force notes that SIFMA and two of its affiliates (the American Securitization Forum and the European Securitisation Forum) have formed a global, joint working group that will work towards developing and publishing actionable industry-developed recommendations with regard to, among other things, disclosure practices of issuers and securitization sponsors, underwriter due diligence practices and reporting standardization, and similar issues. The Task Force endorses this effort and recognizes it as an important natural progression from this Task Force's initiative, one that will further detail what can be done by parties other than the CRAs to re-start our markets, and that can help revitalize the securitization and structured credit markets and bolster investor and public confidence in those markets.

The Task Force recommends that consideration be given in this effort to greater disclosure to investors from issuers and underwriters, which may include the following (subject to appropriate legal analysis in the relevant jurisdictions):

a. Standardization of disclosure of the due diligence process undertaken by the issuer, underwriter, and/or third party due diligence provider on each securitization, including:

    i. Who performed the due diligence;

    ii. What the due diligence analysis entailed (*e.g.*, with respect to RMBS, rules defining the sample selection, sample size as a percentage of the pool, percentage of sample loans removed from the securitization for non-conformity to stated characteristics in offering documents, and the reasons for removal from the pool); and

    iii. The results of this due diligence, including what exceptions were noted;

b. Standardization of initial or periodic disclosure of collateral characteristics, on an asset-class basis, in line with SIFMA/ASF/ESF-generated templates;

c. Historical performance of similarly underwritten pools, if relevant;

d. Disclosure of additional data elements in standardized periodic remittance reports (such as FICO or other consumer credit scores, loan to value ratios, and others), to enhance transparency and risk assessment of structured finance securities on an ongoing basis;

e. Standardization of remittance reports by asset class, to facilitate greater transparency in the market; and

f. Standardization of commonly used definitions, to the extent feasible.

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Appendix A: Roster of SIFMA Credit Rating Agency Task Force Members

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