

Executive Roundtable and Professional Placements

2 – 10 October 2008 • Melbourne, Canberra and Sydney

Session 7, Part 2

Emerging Best Governance Practices in Commercial Financial Institutions:
Credit Rating Agencies: Recent International and Domestic Developments

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Executive Summary

- Recent inquiries into the sub-prime market events have highlighted the role that credit rating agencies (CRAs) played in contributing to turbulence in the global financial system. This has drawn policy and regulatory attention to the activities of CRAs in an effort to determine what measures can be taken to better oversee their conduct, improve their performance and moderate reliance on their ratings.
- To date, the global response has led to the:
 - Relevant United States (US) regulator, the Securities and Exchange Commission (SEC), investigating allegations of misconduct in the way CRAs manage their affairs. It has also called for regulatory reform;
 - European Commission and the Committee of European Securities Regulators (CESR) calling for some form of Europe-wide or global standard setting agency for CRAs; and
 - International Council of Securities Commissions (IOSCO) issuing a revised and strengthened self-regulatory code for CRAs. The Financial Stability Forum (FSF) has also called for better oversight of CRAs and identified the work of IOSCO as the way forward for addressing concerns about CRAs.
- In summary, the focus of the response so far is on better management of CRAs' conflicts of interest and greater competition in the industry as well as more informed decision making by investors of the services provided by CRAs.

- Against this backdrop, Australia is to review its existing domestic policy and regulatory arrangements and consider the nature of any response to measures proposed by other countries and multilateral bodies. Treasury and ASIC are to report to the Minister for Superannuation and Corporate Law on these matters before the end of this year.

Introduction

A joint review paper, including proposals for consultation, will be released by Treasury and ASIC in the coming weeks.

The paper provides an overview of recent international responses to the role of CRAs in the recent market turmoil. It outlines major developments in the US as well as in multilateral organisations such as the Technical Committee of IOSCO and the FSF as well as the EU.¹

In addition to outlining recent important international developments, the paper also outlines Australia's current regulatory approach to CRAs and provides an overview of the recent Credit Ratings Agencies Review (the Review) announced by the Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry. The Review will position Australia to respond to the policy and regulatory challenges raised by CRAs.

International Developments

It is widely acknowledged that CRAs and their ratings played a critical role in recent market turmoil. As discussed in the IOSCO CRA Task Force Consultation Report on *The Role of Credit Rating Agencies in Structured Finance Markets*, credit ratings have had an 'inordinate impact' on the valuation and liquidity of sub-prime residential mortgage-backed securities (RMBSs) and collateralised debt obligations (CDOs) (collectively, 'structured finance products').²

In part, this was a result of many investors and market participants effectively outsourcing their own valuations and risk analyses of complex structured finance products to the CRAs. Underlying this, however, are concerns with the quality and integrity of the rating process, including CRAs' lack of independence from issuers and their alleged failure to avoid conflicts of interest.

The IOSCO report notes 'serious questions' surround whether the CRAs should have reassessed their methodologies and underlying assumptions when rating structured finance products, given credible information regarding housing market bubbles in the US, the lack

¹ IOSCO is the international cooperative forum for national securities regulatory agencies. Its Technical Committee is the key 'standard-setting' body through which major jurisdictions negotiate shared regulatory frameworks for common market issues.

² This Consultation Report is available online at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf>.

IOSCO's media release is online at: <http://www.iosco.org/news/pdf/IOSCONEWS114.pdf>

of incentives for mortgage lenders to conduct proper due diligence, and a possible increase in mortgage fraud.

There are additional concerns given that CRAs and their analysts were increasingly involved in providing advice on the design of structured finance products. In this way, CRAs took a different approach to rating structured finance products from rating ordinary corporate debt. This raises conflict of interest issues.

The US and CRAs

The *Credit Rating Agency Reform Act of 2006 (US)* replaced a voluntary CRA regime in the USA with a registration-based system of regulatory oversight for nationally recognised statistical rating organisations (NRSROs). Prompted by the Enron collapse, the regime requires each NRSRO to register and enforce written policies and procedures in a range of areas, including the misuse of non-public information and managing conflicts of interest. NRSROs are required to certify annually that registered documents remain accurate. The SEC has exclusive enforcement authority over any NRSRO that issues credit ratings contrary to their registered procedures.³

Given the US origins of the current turmoil, there is some pressure in that jurisdiction for additional CRA oversight if reforms currently being adopted by the CRAs are not sufficient to ensure the integrity and transparency of their ratings.

The key forum in the US through which these debates are being handled is the President's Working Group on Financial Markets (PWG). The PWG is a cross-agency forum chaired by the Secretary of the Treasury and also comprising the Chairs of the Federal Reserve Board, the SEC, and the Commodity Futures Trading Commission.

On 13 March 2008 the PWG issued a policy statement setting out the group's initial analysis of the causes of recent market issues and its recommendations for improving the state of financial markets. Flaws in CRAs' assessments of structured finance products have been described by the PWG as one of the 'principal underlying causes' of recent market turmoil. The PWG has thus called for reform of CRAs' processes for, and practices regarding, rating structured credit products.⁴

On 11 June 2008, the SEC released three sets of proposals for CRAs in light of sub-prime issues. The draft rules address similar CRA issues to other international reviews, including conflicts of interest, disclosure, transparency, and investor protection. One of the three sets of draft rules is devoted to differentiating between ratings given to structured products and bonds, emphasising the stronger focus placed by the SEC on this issue than by other reviews.

³ A summary of this regime is available online at: <http://www.glin.gov/view.action?glinID=190699>. The USA SEC's final implementing rules are also online at: <http://www.sec.gov/rules/final/2007/34-55857fr.pdf>

⁴ Available online at: http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf

On 8 July 2008, the SEC released the findings from its 10-month examinations of three major CRAs (Fitch Ratings Ltd, Moody's Investor Services Inc. and Standard & Poor's Ratings Services). The examinations found significant weaknesses in CRAs' practices and disclosure to investors. These included issues relating to:

- (a) conflicts of interest;
- (b) dealing with increased volume of RMBSs and CDOs;
- (c) transparency of policies and procedures; and
- (d) internal audit processes.

The report also concluded that CRAs had already begun to address these problems by implementing reforms based on international concerns.

IOSCO and CRAs

A request from the FSF in April 2007 prompted the IOSCO Technical Committee to re-establish its CRA Task Force. Given early warning signs in the USA sub-prime market and related concerns with the credit ratings held by structured finance products, the CRA Task Force was asked to analyse the role of CRAs in structured finance markets and consider whether or not IOSCO's 2004 *Code of Conduct Fundamentals* (2004 code) required enhancement.

The 2004 code was developed as a joint project that included securities regulators, Basel Committee members and representatives of the CRA industry. It is a voluntary framework for firm-specific codes, which CRAs are expected to adopt on a 'comply or explain' approach. The original purpose of the 2004 code was to strengthen transparency and address potential conflict of interests in this industry.

The CRA Task Force released a Consultation Report and proposed revisions to the 2004 code on 26 March 2008.⁵ The Final Report, released on 28 May 2008, proposed expanding on the 2004 code to strengthen CRA processes and procedures, in relation to:

- the quality and integrity of the rating process (including CRAs taking reasonable measures to use information of sufficient quality and prohibiting their analysts from providing advice on the design of structured finance products);
- independence and avoidance of conflicts of interest;
- clarifying CRA responsibilities to the investing public and issuers; and
- additional communication with market participants.

As a correspondent member of the CRA Task Force, ASIC attended only those meetings that coincided with other international gatherings. ASIC approved both the draft and final

⁵ The Consultation Report and revised 2004 code are available online at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf>. IOSCO's media release is online at: <http://www.iosco.org/news/pdf/IOSCONEWS114.pdf>

report and proposed revisions without expressing strong views on any substantive matters.

The revisions at an IOSCO level to the 2004 code will require ASIC to, at a minimum, review and update [CO 05/1230] to ensure that the new code is complied with by CRAs operating in Australia. Exemptions under the class order [CO 05/1230] require compliance with the 2004 IOSCO code.

Europe and CRAs

Many of the issues explored by the US PWG and IOSCO CRA Task Force have also been recently reviewed in the European context.

In September 2007 the EU Commission sought advice from the Committee of European Securities Regulators (CESR) in addition to CESR's annual report on CRA compliance with the IOSCO code.⁶

On 13 February 2008 CESR issued a consultation paper on its preliminary conclusions, titled 'The role of credit rating agencies in structured finance'. The paper addressed a number of key issues including the importance of transparency of methodologies, the monitoring of ratings and conflicts of interest with respect to CRAs and structured finance products.⁷

CESR finalised its advice to the European Commission on CRAs and structured finance in May 2008.⁸ While concluding that there was 'no evidence that regulation of the credit rating industry would have had an effect on recent market turmoil, CESR urges the EC to establish an international standard setting and monitoring body', at least at the European level if not globally.

On 8 July 2008 the Economic and Financial Affairs Council of the European Union (Ecofin), the institution of EU member states' economic and finance ministers, endorsed in principle CESR's recommendation that CRAs should be subject to an EU registration system and more stringent implementation of international standards.

The European Commission has moved quickly in response to Ecofin by issuing on 31 July 2008 a draft directive on EU registration.

⁶ CESR is an independent coordination and advisory body within the EU system.

⁷ The consultation paper is available online at: http://www.cesr-eu.org/index.php?page=consultation_details&id=108

⁸ See CESR's Second Report to the European Commission (May 2008), available online at: <http://www.cesr.eu/popup2/php?id=5049>

See also press release, "CESR takes steps to strengthen market confidence" (17 April 2008), available online at: http://www.cesr-eu.org/index.php?page=home_details&id=283

Engagement by the G7 and the Financial Stability Forum and CRAs

The FSF reported to the G7 Ministers and Governors meeting on 11 April on ‘Market and Institutional Resilience’ (the FSF Report).⁹

The FSF Report reviewed the underlying causes of recent market turmoil and the weaknesses that were revealed. It also recommended action plans on a number of areas. In relation to CRAs, the FSF Report made the following relevant points:

- Investors need to reduce over-reliance on credit ratings;
- CRAs need to address potential conflicts of interest, improve the quality of their ratings and expand the related information they provide so that investors are better placed to make their own credit judgements;
- CRAs should clearly differentiate, either with a different rating scale or with additional symbols, the ratings used for structured products from those for corporate bonds, subject to appropriate notification and comment;
- CRAs need to improve the assessment and scrutiny of the quality of the data underlying the ratings; and
- Authorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.

The ongoing work of IOSCO was noted in the FSF Report as a key means to achieve the desired outcomes dealing with CRAs.

Global industry responses

In addition to governmental and international organisation responses to CRAs, industry has also taken some initiatives. Internationally, the major global CRAs have been active in reviewing their internal practices and adopting new initiatives in light of global market events.

On the issue of additional external oversight via formal regulation, a joint response by the major global CRAs to CESR’s February Consultation Paper noted:

[The Participating CRAs¹⁰] are subject to direct supervisory oversight in certain jurisdictions including the United States... We believe that the

⁹ Glenn Stevens, Governor, Reserve Bank of Australia represents Australia on the FSF. A settled, public version of the FSF Report is available online at: http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf

¹⁰ The ‘Participating CRAs’ include: A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc.; Moody’s Investors Service, Inc.; and Standard & Poor’s Rating Services. Each is registered with the US SEC as a Nationally Recognised Statistical Rating Organisation (NRSRO).

creation of a parallel, regulatory regime in Europe could substantially increase the regulatory burden without generating sufficient, incremental benefits beyond those that could be achieved through more extensive and intensive collaboration between CESR and the SEC.

This response also suggested that, in Europe, market disciplinary forces have proven effective in persuading CRAs to implement the existing 2004 IOSCO code and amend their own codes where market participants or regulators have raised concerns.

Regulation of CRAs in Australia

With the changes to the *Corporations Act 2001* (Cth) (the Act) flowing from the introduction of Financial Services Reform (FSR) measures, CRAs were treated as being engaged in providing financial product advice and were required to hold an Australian Financial Services Licence (AFSL) unless granted an exemption by ASIC¹¹. At that time most foreign jurisdictions did not subject CRAs to regulation.¹² Therefore, ASIC initially granted an interim licensing exemption to CRAs.¹³

In 2005 ASIC publicly consulted on ongoing licensing relief for CRAs.¹⁴ After considering feedback on that paper, ASIC granted ongoing licensing relief under Class Order [CO 05/1230] in December 2005.¹⁵ This class order applies where the named credit rating agencies (including Moody's Investors Service Pty Ltd and Standard & Poor's (Australia) Pty Ltd) meet certain conditions, such as complying with IOSCO's 2004 code.

Australian Developments

Media reports have largely focussed on US products and global debates, since, on the whole, Australia has not experienced the levels of ratings-related market turbulence felt abroad. This is due to a number of factors, such as Australian banks having had only small indirect exposures to US sub-prime debt, and Australia's growing economic relationship with robust emerging markets such as China.

¹¹ s911A of the *Corporations Act 2001*

¹² The comparative position overseas has shifted somewhat since; consider, the current US position outlined in this paper.

¹³ For further detail, see: Information Release [IR 02/28], at:

<http://www.fido.gov.au/asic/asic.nsf/byheadline/IR+02%2F28+ASIC+continues+no-action+licensing+approach+for+debt+rating+agencies+during+FSR+transitional+period?openDocument> and Information Release [03-43], at: <http://www.fido.gov.au/asic/asic.nsf/byheadline/IR+03-43+ASIC+provides+temporary+relief+during+period+of+consultation+?openDocument>

¹⁴ See ASIC Information Release [IR 05-30] and the June 2005 consultation paper, *Licensing: credit rating agencies*. Available online at: <http://www.asic.gov.au/asic/asic.nsf/byheadline/IR+05-30+ASIC+seeks+industry+comment+on+proposed+licensing+exemption+for+credit+rating+agencies?openDocument>.

¹⁵ See Information Release [IR 05-63] and Class Order [CO 05/1230], available online at: <http://www.asic.gov.au/asic/asic.nsf/byheadline/IR+05-63+ASIC+provides+ongoing+licensing+relief+for+credit+rating+agencies?openDocument>.

There has, however, been coverage of local councils and similar entities in Australia being exposed to structured finance products that held AAA credit ratings despite being linked to sub-prime mortgages.¹⁶ In addition, a recent report to the NSW Government by Michael Cole on a 'Review of NSW Local Government Investments' (April 2008) includes a recommendation that investment by councils in products with certain kinds of credit ratings 'be suspended and subject to a further review to determine the relevance of using a credit ratings approach to determining authorised investments, particularly, in light of the current CDO experience'.¹⁷

The Government's Response

On 22 May 2008, the Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry, requested that Treasury lead ASIC in a joint task-group to inquire into international developments and the regulation of CRAs and research houses in Australia.

The taskgroup is to report to the Minister later this year. The Minister's media release on the matter is attached to this paper.

¹⁶ See, for example, ABC Inside Business, "Local councils hit by subprime", 17 February 2008. Available online at: <http://www.abc.net.au/insidebusiness/content/2007/s2164831.htm> Accessed 2 April 2008.

¹⁷ See recommendation 4 in the report a 'Review of NSW Local Government Investments' (April 2008) available online at http://www.dlg.nsw.gov.au/dlg/dlghome/dlg_DocumentsIndex.asp?sectionid=1&documenttype=10&mi=31

Australian Review of Credit Rating Agencies¹⁸

Senator the Hon Nick Sherry, Minister for Superannuation and Corporate Law, today announced that he has asked the Treasury, working closely with the Australian Securities and Investment Commission (ASIC), to review the regulation of credit rating agencies (CRAs) and research houses in Australia.

"There have been some very serious concerns voiced to me about the role CRAs may have played in some aspects of recent financial market problems, including the U.S. sub-prime mortgage situation – so we need to make sure the system is up-to-date."

"I have asked Treasury and ASIC to immediately review the regulation of credit rating agencies and to seek input from the Australian Prudential Regulation Authority (APRA) and other relevant agencies, together with stakeholders from the investor, shareholder and superannuation communities," Minister Sherry said.

In addition to CRAs, the review will examine financial product research houses, in particular the role they played in the provision of advice to investors in several major recent corporate collapses, such as Westpoint.

"In relation to research houses, I've requested a review of the appropriateness of the current regulatory framework and whether it might also require updating."

"To ensure we get the full picture, the review will also look at how ratings advice is used by retail and wholesale investors. As such, I have asked Treasury and ASIC to consult with key investor groups such as the Securities and Derivatives Industry Association, the Investment and Financial Services Association, the Association of Superannuation Funds of Australia and the Australian Shareholders' Association," Minister Sherry added.

Minister Sherry also held extensive discussions on international efforts regarding CRAs with Mr Greg Tanzer, Secretary General of the International Organisation of Securities Commissions at a recent meeting in Spain.

"Enhancing the operation, transparency and effectiveness of financial system gatekeepers like CRAs is of paramount concern to this Government," said Minister Sherry.

The review will commence work immediately and report to the Government within six months.

Canberra

22 May 2008

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¹⁸ <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/026.htm&pageID=003&min=njs&Year=&DocType=0>