



Ref.: CESR/

The role of credit rating agencies in structured finance

CONSULTATION PAPER

February 2008



EXECUTIVE SUMMARY

Background

1. In September 2007 the EU Commission issued an additional request for CESR to review the role of credit rating agencies (CRAs) as part of its annual report on their compliance with the IOSCO Code.
2. The request highlighted that CESR should focus on a number of key issues with respect to the role of the CRAs, particularly their structured finance activity.

Purpose

3. The purpose of this consultation document is to seek comments on the conclusions CESR has drawn from its market survey and evidence gathering from S&P, Moody's Investment Services, Fitch Ratings and DBRS. The consultation also seeks views on the positive and negative aspects of the current self-regulatory regime compared with a possible formal regulatory regime.

Areas Covered

4. **Transparency of rating processes and methodologies:** In particular the consultation focuses on the ease of investor access to information on key limitations and assumptions in complex structured finance methodologies. The paper also seeks opinions on the procedures followed by the rating agencies when applying changes to their methodologies, for example, on the need for clear disclosure to investors of which methodology a rating is based on.
5. **Monitoring of rating performance:** CESR would welcome market views on the need for regular public disclosure of structured finance rating performance and the need for CRAs to maintain sufficient resource and organisational flexibility to act promptly in reviewing structured finance ratings.
6. **CRA staff resourcing:** The consultation seeks market participants views on the whether CRAs were adequately resourced for the volume and complexity of structured finance ratings they were producing and whether there needs to be more transparency from the CRAs over their resourcing and levels of staff experience. Also, CESR asks whether market participants agree that more clarity and greater independence is desirable for analyst remuneration at the CRAs.
7. **Conflicts of interest:** The key focus of the consultation is on whether the nature of CRA interaction with issuers during the structured finance presents additional, un- or poorly managed conflicts of interest leading to reduced rating integrity; whether the CRAs activities constitute advisory activity in this area; whether some of the ancillary services offered may lead to potential conflicts of interest and whether greater disclosure is required on the fees CRAs earn from structured finance activity as a result of the "issuer pay" model and the specific "success" fee structure for this activity.
8. **Regulatory options:** CESR requests market views on the benefits and costs associated with the current self-regulatory regime and a possible formal regulatory regime; and market views on whether the current regime should be maintained or a regulatory regime for CRAs established.

Response Deadline

9. The deadline for responses to this consultation is **31 March 2008**.



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INTRODUCTION

10. On 30 March 2005, at the request of the European Commission, CESR delivered its advice (CESR/05-139b) regarding the potential options to regulate Credit Rating Agencies (CRAs). In its advice, CESR proposed not to regulate the Credit Rating Agencies industry at an EU level for the time being, and instead proposed that a pragmatic approach should be adopted to keep under review how CRAs would implement the standards set out in the IOSCO Code of Conduct.
11. CESR therefore developed this strategy on the basis of voluntary participation from CRAs and in December 2005 published a press release outlining the process to review implementation of the IOSCO Code.
12. This framework, agreed with the main CRAs operating in the European Union, included three elements: (i) an annual letter from each CRA to be sent to CESR, and made public, outlining how it had complied with the IOSCO Code and indicating any deviations from the Code; (ii) an annual meeting between CESR and the CRAs to discuss any issues related to implementation of the IOSCO Code; and (iii) CRAs would provide an explanation to the national CESR member where any substantial incident occur with a particular issuer in its market.
13. DBRS, Fitch Ratings, Moody's, Standard and Poor's adhered to this voluntary arrangement.
14. In January 2006 the European Commission published a Communication setting out its approach to credit rating agencies. In line with the advice provided by CESR, the Commission concluded that at that moment no new legislative proposals were needed. The European Commission considered that the existing financial services directives, combined with self-regulation by the CRAs on the basis of the IOSCO Code, would provide an answer to all the major issues of concern in relation to CRAs. However, the communication concluded that there was a need for the Commission to monitor the global development of the rating business and for CESR to monitor compliance with the IOSCO Code and to report back to the Commission on an annual basis.
15. On 17 May 2006, CESR received a letter from the European Commission formally requesting CESR to report on credit rating agencies' compliance with the IOSCO Code by the end of 2006. In its formal letter the Commission requested CESR not only to carry out the theoretical work of comparing codes, but also to assess the level of day to day application of the IOSCO Code in practice.
16. In January 2007, CESR published the requested report (Ref. CESR/06-545), concluding that the CRAs did not fully comply with the IOSCO code when it came to unsolicited ratings and ancillary services. These areas, together with the structured finance area, were therefore decided to be further investigated in the next review (the one CESR is currently working on).
17. In May 2007, CESR received a letter from the European Commission asking CESR to monitor the voluntary compliance with the IOSCO code and to prepare its second report.
18. In June 2007, CESR launched a questionnaire addressed to all interested parties regarding the rating of structured finance instruments. This call for evidence closed on 10 September. A detailed analysis of the responses provided by the CRAs and by market participants to this questionnaire is included in section II of this report and in Annex I.



Furthermore, the responses are available on CESR's website under 'consultations'/'past consultations and responses'.

19. In September 2007, the Commission expanded its request to the CESR task force to include an investigation whether the recent developments within structured finance would cause CESR to change its view whether to regulate CRAs or not.
20. In particular, the Commission has asked CESR to gather additional data in this year's report and provide its views about the following areas of the rating process regarding structure finance instruments:
 - Transparency of CRAs rating methodologies;
 - Human resources allocated to rating and monitoring;
 - Periodic monitoring of the ratings and timeliness of rating actions;
 - Potential conflicts of interest (i.e. remuneration structures of CRAs).
21. As planned and envisaged in CESR's existing work plan, the CESR Task Force held separate hearings on the 4th and 5th of October with the 4 CRAs. During these sessions, the CRAs provided CESR with updated information on their codes of conduct, discussed the Commission's new request including their views on the sub-prime crisis and particularly on how they intended to address any possible shortcomings in this market.
22. In November 2007, as a follow up to the meetings held with rating agencies at the beginning of October and in order to obtain the necessary data to fulfil the European Commission's new request, CESR sent a letter asking for additional information to the CRAs. CESR has published on its website the list of questions and the answers provided by the CRAs (except those expressly requested by the CRAs to be kept confidential).
23. CESR set up a task force responsible for following the steps outlined in CESR's voluntary framework and for developing the reports to the Commission. The task force, which is the same as the one that prepared the March 2005 advice to the Commission, consists of representatives of the Belgium, German, French, Spanish, Italy, The Netherlands, United Kingdom, Portugal and Sweden CESR members. The task force is chaired by Ms Ingrid Bonde, Director General of the Swedish Finansinspektionen and supported by Raquel García Alcubilla and Javier Ruiz from the CESR secretariat. In addition, representatives from the Commission and from the Committee of European Banking Supervisors (CEBS) take part in the task force as observers.
24. The source of information that CESR has used for the preparation of this report is the input received from the CRAs and market participants in the manner described above. As mentioned before, some of the information obtained from the CRAs has not been published as the agencies expressly requested that information to be kept confidential. The confidentiality refers mainly to human resources or revenue related data.
25. Apart from the above, CESR is going to take into account the main initiatives that are being undertaken by securities regulators and other governmental bodies to assess how markets have reacted to the structured finance market turmoil and how regulators and market participants are reacting. As these initiatives are now underway but have not been finalised yet, CESR has not been able to factor into this consultation paper any conclusions made in these fora.
26. Two of the main streams of work resulted from the decision of the Financial Stability Forum (FSF) in March 2007 to request IOSCO, the Committee on the Global Financial System (CGFS) and other interested member bodies to explore whether there were any outstanding issues related to the role of CRAs in structured finance.



- **IOSCO's** Technical Committee, at its meeting in April 2007, agreed that its Credit Rating Agencies Task Force would undertake a study of how CRAs go about rating structured finance products and whether any amendments should be made to the IOSCO CRA Code of Conduct to reflect conflicts of interest or other problems that arise in rating structured finance products. This study is going to be part of a wider report on subprime market turmoil that is expected to be published around the end of March.

The FSF's first decision was followed by another one in October 2007, to create a Working Group on Market and Institutional Resilience in the wake of the turmoil in the markets during the summer months.

- In this context, IOSCO created in November 2007 a dedicated Task Force on the subprime crisis to review the issues facing securities regulators following the recent events in the global credit markets. The Task Force will conduct a preliminary review of the issues raised by these events in order to identify any implications for securities regulators which could be addressed through current and future IOSCO work. The study on CRAs mentioned above will feed into this review.
- The **CGFS** is currently updating its January 2005 Report¹ on the role of ratings in structured finance. CGFS expects to finalise by March this update in order to feed the FSF due by April 2008.

27. The US Securities and Exchange Commission (**SEC**), using the authority granted by the Credit Rating Reform Act 2006, is currently undertaking an examination of the records of the NRSROs. This could eventually lead to proposals for amending the current SEC regulation on NRSROs.

28. The European Securities Market Expert (**ESME**) group has also been requested by the EC to produce a report on the role of CRAs in structured finance. This report is expected by end of April 2008.

29. CESR acknowledges that any initiative on rating agencies must follow this global perspective and, to this effect, the task force has worked in close co-operation with the following bodies:

- CEBS has participated as an observer to the task force meetings and its contributions have been very helpful for the task force.
- The SEC has showed its willingness to collaborate with CESR and has informed regularly the task force of the developments in the US. CESR secretariat has been invited to the SEC to get first hand information on the application of the new US legislation and representatives from the SEC have attended some of the task force meetings as observers.
- IOSCO's work has been closely followed by CESR, being some of the members of the CESR's CRAs task force also active members of the IOSCO's CRAs task force. Besides, on going contacts at Secretariat level are kept.

Purpose

30. The purpose of this consultation document is to seek comments on the conclusions CESR has drawn from its market survey and evidence gathering from S&P, Moody's

¹ "The role of ratings in structured finance: issues and implications" (January 2005)



Investment Services, Fitch Ratings and DBRS. The consultation will also seek views on the positive and negative aspects of the current self-regulatory regime compared with a possible formal regulatory regime.

Public consultation

31. The consultation period closes on **31 March 2008**. Respondents are invited to send their comments via CESR's website (www.cesr.eu) under the section "Consultations". CESR acknowledges that this is a short period but it results from the Commission's deadline to CESR. CESR will assess the responses received and revise its proposals if necessary. All responses that have not been labelled as confidential will be published on CESR's website.
32. As part of the consultation process on this paper, **hearings for interested parties other than CRAs**, will be held in **Paris**, at CESR's premises, on **26 March 2008**. An agenda for the hearings will be available on the CESR website. Subscriptions to attend the hearings can be made via CESR's website under the section "hearings".
33. CESR expects to submit the final report to the Commission in May 2008.



I. BACKGROUND

The role of CRAs in structured finance

34. CRAs play a significant role in capital markets, providing a key source of information on credit risk to investors. As a reminder, according to the definition included in the IOSCO Code of conduct, a credit rating “*is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system*”. Therefore, according to this definition, CRAs ratings are opinions on creditworthiness but not on the price or liquidity characteristics.
35. Structured finance consists of the pooling of assets and the subsequent sale to investors of tranching claims on the cash-flows backed by these pools², usually through a Special Purpose Vehicle (SPV). Over the past 5 years, the issuance volume of structured finance products soared partly as a result of the search for alternatives in the context of the declining attractiveness of returns, but also driven by the incentive for banks to take loans off balance sheets. The volume of structured finance issues in Europe was estimated at €450 billion in 2006 and growth in the first half year 2007 is believed to reach close to 70%.
36. Two main characteristics of structured finance products are the pooling of assets and the tranching process which is designed to create seniority ordering among the different tranches of securities. Senior classes of securities are designed in order to be immune, to a certain extent, from default losses, which are initially borne by riskier (equity and mezzanine) tranches. This segmentation enables the product to appeal to investors with different risk profiles.
37. These characteristics however imply a high level of complexity, as the tranching process consists of legally organizing the distribution of cash-flows from the asset pool to different tranche investors. In order to adequately assess these instruments, an investor needs to gauge the credit risk of the underlying (heterogenous) collateral assets but also to have sufficient insight into the legal structure and the specific provisions of the transaction (eg, implication of asset managers) that organize the different seniority levels of the tranches.
38. Due to this complexity and the rising interest of larger categories of investors, which often do not have the resources, time or expertise for a thorough analysis of the risk of the available securities, the market has come to heavily rely on credit ratings. They form the easiest source of information and a standardized evaluation of structured finance transactions. In that sense, ratings help reduce the information asymmetry. Moreover, ratings, and particularly investment-grade ones, are also a requisite in order to market senior tranches to those asset managers with rating-based investment restrictions. However, ratings for structured finance products are designed purely to represent the likelihood of default and do not indicate market valuation and liquidity risk, meaning that risk assessment based purely on these ratings will not cover the full range of risks associated with these investments.
39. CRAs have thus developed and continue to adapt methodologies (model-based) to rate structured finance transactions, which grew to account for an increasingly significant part of their revenues and income. In 2006, structured finance ratings represented on average 50% or more of the 4 biggest CRAs revenue. Fees as a percentage of the

² As defined in the BIS report, “The role of ratings in structured finance : issues and implications”, January 2005.



nominal value of the transaction are believed to be 2 to 3 times higher for structured finance than for traditional ratings.

40. The difference in the rating process may explain this variance in fee levels. Not only are the ratings more complex and time consuming due to their very nature but also the rating of structured finance transactions distinguishes itself from the rating of traditional instruments by the greater flexibility to adapt the features of the transaction in order to achieve the rating level desired for each tranche of the structure. As opposed to traditional ratings, the rating of a structured finance transaction is a target, not the outcome of the rating process. Therefore, CRAs have taken a more important and involved part in a deal's structuring process, with criticism from some quarters that their involvement is now actually advisory. Arrangers use CRAs' models to structure the deal and subsequently go through an iterative process with the CRA, with the ultimate goal for the issuer being to maximize the size of the tranche(s) with the highest rating or minimize the cost/quality of assets used to reach a high rating tranche or minimize the level of credit protection needed for a certain tranche. Compared to their initial role of a third-party monitor of credit default risk on the basis of preexisting financial and economic conditions, CRAs seem to have taken a much more interactive role in the deal process when it comes to structured finance transactions.

Why is this an issue for review?

41. The role of CRAs in structured finance issuance has been a source of debate for some time. In previous reports, CESR had already questioned the implications of this role on CRAs' independence and the possibility of increased risk of conflicts of interest.
42. However, the recent US subprime mortgage driven crisis has brought the concerns regarding the role of CRAs in structured finance ratings and the need for a thorough analysis of their involvement in the current turmoil to the forefront of the international regulatory agenda.
43. An aspect that has been highlighted regarding the rating of structured finance instruments is the fact that CRAs are paid fees by issuers and not by investors. Although this is also the case with corporate ratings, the nature of structure finance means that issuers can bring repeat business to the CRAs. This might drive them to favour business volume instead of rigorousness and independence and hence to 'overrate' transactions in order to maintain a profitable flow of business from arrangers. This issue has already been largely debated before, CRAs explaining that their reputation risk was an effective counterbalance. However, the surge in structured finance fees which are based on an initial transaction fee plus a fixed fee for monitoring (and potential consequent rise in directors/analysts remuneration), combined with the iterative approach to these ratings in comparison to corporate ratings necessitates a review of this issue.
44. A related issue is that of CRA's analysts taking part in fees negotiation. Although this practice is in opposition with principle 2.12 of the IOSCO Code of Conduct and CRAs adhere to the general rule, some CRAs have admitted there are exceptions. This is particularly the case in complex structured finance deals where rating staff may be involved in discussing the amount of work that has to be done as it also has an impact on fees³. However, as summarized in the last section of the consultation paper the CRAs have made improvements in this respect.

³ See CESR's 2006 report (CESR/06-545), §51.

45. Some observers have also raised concerns about the limited number of investment banks bringing structured finance business to CRAs, increasing the risk of client dependency, and hence of conflict of interest.
46. Another area of potential conflicts of interest that has already been identified and tackled by the IOSCO Code of Conduct is the issue of “ancillary services”. Although the scope of these services is sometimes difficult to define (eg. is a rating assessment service part of the rating services or is it an ancillary service?), the IOSCO Code requires operational and legal separation of the credit rating business from any other business undertaken by CRAs that may present a conflict of interest. CESR’s 2006 report⁴ to the EC on the compliance of CRAs with the IOSCO Code pointed to the deviation of some CRAs from this principle.
47. With regard to structured finance, the continuous innovation seen in the market has resulted in the creation of more and more complex instruments, increasing the opacity for investors. As a result, investors have come to heavily rely on ratings and CRAs’ rating reports as a source of information, including for purposes for which ratings were not designed (ratings being indicators of default risk only). This trend has been exacerbated by the lack of a liquid market for these securities leading to problems in pricing them efficiently. As a result of the demand from investors lacking sufficient information to be able to mark-to-market these securities, some CRAs have developed pricing services for structured finance securities. Although CRAs claim that the pricing services they offer are independent from the rating services, market participants have pointed out that there is a need to clarify the level of interaction between those two businesses and the controls in place to prevent conflicts of interest affecting ratings. Examples of possible conflicts are the potential use of information gathered for the rating process to later price the security or the potential reluctance of the CRA to unfavorably price a security to which it has itself attributed a superior rating. The questions posed by the offering of these services have become all the more acute in the context of the recent turbulence in the markets that has highlighted the importance of the valuation of assets.
48. A key issue with regard to pricing and lack of transparency is the fact that, as ratings have become a significant, if not the most significant, factor in the marketing of structured finance securities and also become a prime source of information for investors, the market seems to have disregarded the limitations of ratings in gauging the risk of structured finance products and to have lost sight of core risk management principles. This trend may be summed up in the following: “it’s AAA rated so it’s safe, valuable and liquid”. While the subprime mortgage crisis had already been evident for some months, a lot of investors seem to have discovered only late in the day that some of the investment grade rated products they had bought were in fact heavily exposed to subprime mortgage bonds. They also appear not to have been aware that the liquidity characteristics of these products differed significantly from corporate bonds, particularly in an adverse market environment.
49. Although CRAs state that ratings are not designed to be, and cannot be, predictors of market prices or product liquidity, the question of the lack of investor’s comprehension of the role of credit ratings in structured finance needs to be raised for consideration by CRAs and regulators. It is linked to the issue of the availability of ratings reports and deal documentation but also to the intrinsic quality of the information made available by arrangers and the CRA. There clearly appears to be a widespread misunderstanding of CRAs do’s and don’ts about structured finance, of what information ratings provide or not, of their reliability and the extent of comparability between, for example, an

⁴ Ibidem.



AAA-rated corporate bond and an AAA-rated CDO tranche. As described in the BIS report⁵, “ a number of investors ... claim to rely almost exclusively on the rating agencies’ pre-sale reports and rating opinions for information on deal specifics and performance”. If this is the case, either the information provided was not sufficient to form an educated opinion and perform a risk assessment of deals, or investors did not do their homework correctly, or both.

50. Last but not least, the current crisis has again given rise to criticisms that CRAs were much too slow to react, as was alleged to be the case in previous corporate scandals. The delay in the downgrading process of structured finance securities backed by subprime mortgage assets raises questions on the efficiency of CRAs’ methodologies, the robustness of their historical default models in a relatively new market and their rating surveillance procedures. However, the CRAs point out that the very nature of structured finance leads to a delay in the response of ratings to the underlying asset pools – which becomes more pronounced the further the product is from the underlying – i.e. a CDO reacts after underlying RMBS due to trickle through effect. Respondents to the CESR survey raised questions about the ability of CRAs to keep up with the accelerated wave of financial innovation and the surge in issuing volume from a modeling and human resources point of view. Also practices such as notching, i.e. downgrading by one or more ‘notches’ the rating of an underlying asset attributed by a competitor have been questioned. Finally, in order to improve market understanding of structured finance ratings and rating changes, the transparency of these methodologies, of the way they are applied and of their implications is also under review.

⁵ “The role of ratings in structured finance: issues and implications”, January 2005.



II. CONCLUSIONS OF CESR'S SURVEY ON THE RATING OF STRUCTURED FINANCE INSTRUMENTS

51. In June 2007, CESR launched a questionnaire addressed to all interested parties regarding the rating of structured finance instruments. An analysis of the responses provided by the CRAs and by market participants to this questionnaire is included in this section. Besides, Annex I provides some additional information summarising the responses of the CRAs.

Section A: Credit Rating Agency Responses

52. The CRAs currently earn around 40-50% of their revenue from structured finance ratings. They were all clear that they did not perceive themselves to be offering ancillary services that were not part of their rating business to customers.

53. Only S&P replied that they offered any form of ancillary service which was the provision of models to evaluate and optimise potential securitization. DBRS did indicate that they provide some impact assessment services but considers them as an extension of its relationship with the issuer.

54. Fee structures were similar, although not identical, to corporate ratings – varying with the complexity of the product being rated. Normally, the fees structure for structured finance ratings include an up-front fee – which is based on a percentage of the nominal value of the debt issue and can be subject to a cap or floor depending on the size of the issue – and a surveillance fee, which is generally a fixed amount, either up front or per annum. The fees will vary depending on a number of factors including asset type and the complexity/innovativeness of the product. Fee information was generally shared only with the arranger although sometimes this was also shared with the originator.

55. However, some at least partial differences between these two “products” concern two aspects:

- The up-front fee for structured finance ratings is always related to the nominal amount of the issue, whereas the first time issuers fee in corporate ratings is in some cases a fixed amount, or only an annual fee is provided;
- Two CRAs pointed out that they can charge additional fees if the nature of the transaction (for example because of its complexity or its innovative characteristics) requires the agency to undertake additional analysis.

56. Concerning the staff remuneration criteria for Structured Finance rating analysts, all respondent CRAs pointed out that analysts' compensation (even its variable part) is determined based on their qualitative performance and the overall performance of the company, whereas it is not related to their specific volume of activities or to the specific level of ratings assigned. For most senior people, in some cases the remuneration is also based on their ability to attain their strategic objectives.

57. The rating process for structured finance also held similarities to corporate finance although the ability of the issuer to alter the structure of the deal to achieve higher ratings is the obvious difference. The process would be affected, in terms of CRA contact with outside parties, by the nature of the deal and its complexity, although this



would still primarily be with the issuer. The CRAs indicated that the increased interaction with participants did not lead to any new conflicts of interest.

58. Whilst the CRAs indicated that they may deal with a diverse range of participants during the rating process the main contacts for the CRAs in the rating process were the arrangers and their agents. The arrangers often act as conduits between the CRA and the originator and other experts (i.e. accountants). Where they feel it is necessary the CRAs will liaise with a number of other parties including transaction lawyers, asset managers, servicers and financial guarantors. In the case of SIVs S&P indicated that the primary relationship would be with the management company. All the CRAs responded that their relationships and dealings with all these parties are governed by their Codes of Conduct, supported by a range of policies, procedures and internal controls.
59. The CRAs indicated that they believed their track history firmly demonstrated the success of their models in providing stable but accurate ratings for structured finance ratings. Whilst CRAs suggested they could use other CRAs ratings they indicated they would need to make a risk assessment as to the quality and applicability of these ratings before incorporating them and they may need to make some amendments based on using these external ratings.
60. Whilst ratings typically demonstrated similar characteristics in terms of regularity of rating movement historically this had been skewed more towards upgrading and multi-notch movements (either upwards or downwards).
61. The agencies had a similar approach to the monitoring of rated products, with monthly/quarterly reviews based on the information cycles for the underlying asset leading onto possible further review and committee assessment. It was unclear if all CRAs had separate monitoring teams dedicated to monitoring issued SF products.
62. All the CRAs answered that though there is typically more interaction with the relevant parties in rating structured finance transactions, compared to corporate rating, they do not believe that this additional contact results in additional conflicts of interest.

Section B: Other Market Participant Responses

63. Market participants are generally satisfied with the access to and availability of structured finance ratings, although they perceive there are in structured finance the same problems, concerning the oligopolistic structure of the CRAs market, as in the regular bond market. Dissemination of rating information is widely considered to be acceptable, but with regard to updates some differences exist based on the type/complexity of deals, the underlying asset composition and analysis in various jurisdictions.
64. Although there is general satisfaction on the disclosure of the standard fee scale, respondents would welcome more disclosure of fees of structured finance product ratings. Moreover, some answers highlight the impossibility of comparisons of fees, for the time being, among CRAs, due to complexity of deals and lack of standardized approach.
65. With regard to rating methodologies, respondents welcome the use of different analytical models for various types of transactions. However they also highlighted the quantity of qualitative assumptions used in structured finance ratings, which can vary significantly between CRAs, and also raised the need to continue to improve modelling.

66. Some answers express the concern that CRAs' structured finance ratings only address the probability of default and/or expected loss and do not address the likelihood of future rating actions, the stability of ratings or secondary market prices. The respondents felt that these were necessary measures for evaluating the risks of structured finance products.
67. Generally, respondents felt that rating agencies take a sensible approach to assessing structural risks in transactions, but in some cases market participants believe that the approach taken is too inflexible or conservative. Moreover, market participants recognise inconsistencies among similar transactions and between certain asset classes in the relative importance of certain key risk factors, which they believed could be the result of high staff turnover rate. Consistency among the same CRA in different jurisdictions seem to be a concern as well.
68. On the issue of disclosure of rating methodologies, market participants believe that CRAs disclose methodologies in a proper way, but there is room for improvement. For some asset classes respondents felt transparency of methodologies could be improved further, indicating the disclosure of the impact of quantitative and qualitative factors as a particular requirement. Moreover, market participants indicated that published methodologies only provide the framework for a rating, with individual models not being made public.
69. Concerning on-going surveillance of transactions, market participants generally noticed an increase in the frequency and quality of the information provided by CRAs and issuers/arrangers. However, there was still concern about the varying quality and frequency of updates depending on asset classes and jurisdictions; some respondents pointed out this often reflected the information coming from the underlying asset pool.
70. Generally, respondents consider that CRAs provide reasonable explanation for revisions of ratings and that CRAs make themselves available for questions from market participants. However, there are some concerns regarding the timeliness of upgrades and downgrades of structured finance transactions, because they are perceived as being more reactive than proactive and thus it seems that CRAs restrain the market from timely information. Respondents indicated that the frequency and quality of information from underlying asset pools had a large impact on the CRAs processes in respect of rating changes.
71. Market participants indicated that there are many unique risks associated with structured finance compared to corporate credit ratings. These risks emerge due to the bespoke structures created and the greater number of parties involved. Moreover, risks of structured finance instruments vary dramatically among differing transaction structures, asset classes and jurisdictions, often making the modelling quite complex. Respondents highlighted the main difference between corporate and structured finance as the fact that structured finance transactions involve special purpose vehicles which are exposed to different kinds of risks. Risks can be transferred on a single asset, on a pool of assets, on a single jurisdiction, on multiple jurisdictions, on a wide variety of assets.
72. Little potential for conflicts of interest is seen by market participants with respect to CRAs providing ancillary services. They believe that CRA's increased their internal "Chinese walls" to an adequate level, also as a consequence of the implementation of the IOSCO Code of Conduct. Moreover, a majority of respondents are satisfied with the way CRAs communicate the measures they have put in place to counter potential conflicts of interest.



73. Market participants indicated that they believe that CRA's may not have sufficient staff resources or experience to deal effectively and efficiently with the volume and complexity of ratings for structured finance products.
74. The IOSCO Code of Conduct is seen to be a comprehensive and appropriate way to deal with ratings of structured finance products as well as corporate ratings.
75. Finally, some additional comments made from market participants concern the issues of "down notching", of non-disclosed ratings and the need for more standardised reporting to facilitate the valuation process for investors and other market participants.



III. ANALYSIS OF THE MAIN ASPECTS RELATING TO THE ROLE OF CRAs IN STRUCTURED FINANCE

III.1. Transparency

76. As highlighted earlier in this paper, ratings play a key part in the decision making process of investors when assessing the appropriateness of a structured finance product against their investment criteria, probably more so than with other assets due to the greater complexity of these products and, generally, less access to public information than some other products .
77. Ratings are designed to evaluate a specific element of credit risk associated with holding an asset (for example probability of default) and are not designed to be used as a proxy for pricing, liquidity or other elements of market risk. It appears that due to the complexity of structured finance products investors became over-reliant on credit ratings and also used them for purposes for which they were not intended.
78. Although it is the investors' responsibility to ensure their risk analysis and investment decision making process is robust and thorough, it is not clear to CESR whether the CRAs made real efforts to highlight the limitations of their ratings of structured finance products to market participants. Although all the CRAs make use of disclaimers to highlight the nature of their ratings of structured finance products these are not always given much prominence on the rating opinions. There have been concerns raised that even if the CRAs did not deliberately mislead investors over the meaning and limitations of their ratings they did not act to correct developing misconceptions. CESR notes that there has been some improvement in the level of CRA communications with the market on this issue recently.
79. CESR would highlight the need for the CRAs taking appropriate action on an on-going basis to ensure they clearly communicate the central characteristics and limitations of their rating of structure finance products.

80. Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?

81. All four of the responding CRAs maintain their own website containing sections with rating methodologies and additional information. Most require users to register in order to access relevant information. The agencies state that methodologies are freely available from their websites and applied globally, unless regional specific criteria exist, in which case the different methodologies for various asset classes and regions are available.
82. Responses to CESR indicated that the market is generally comfortable with the manner in which CRAs have chosen to disclose their methodologies and that there has been improvement since the introduction of the IOSCO Code. However, comments were also made indicating that there remains room for improvement, a view shared by CESR. Although all methodologies are available on websites, there is often a degree of complexity in navigating through to the appropriate areas of the sites and tracking changes to particular methodologies. In short, the actual usability of the websites and accessibility of certain information on them should be further improved.
83. **CRAs make their methodologies freely available and that there has been improvement since the introduction of the IOSCO Code. However, CESR believes that further progress by the CRAs in improving the accessibility of the information they provide is**



extremely important to creating greater transparency and encouraging appropriate use of credit ratings.

84. CESR would expect the CRAs to continue to strive to meet investor demand and improve the accessibility of their methodologies and usability of their websites.
85. During the course of its information gathering, CESR found that a major concern was the ability of investors to determine key model assumptions, for example default correlations or expected housing price appreciation for RMBS, used within structured finance methodologies and their relative impact on the rating. Whilst some of the CRAs indicated that they were introducing services to assist investors in assessing the impact of various assumptions on their ratings these would not be freely available.
86. Although the CRAs make their methodologies available, an understanding of the key underpinning assumptions, such as the estimated correlation of obligors in the asset pool or the cross-correlations, would greatly assist investors in assessing whether the rating is based on expectations that are in-line with their own. One of the distinctive characteristics of structured products is the fact that changes to these assumptions and the related correlations have an impact on the rating that can be greatly magnified. Whilst CESR recognises that the CRAs' models and methodologies are one of their key competitive features, greater transparency of key model assumptions would improve investor ability to properly use ratings when performing their due diligence and improve their confidence in them. It would be regrettable if the CRAs developed this as a separate service.
87. Independently of the pure transparency aspects, concerns have been raised about the relevancy of the methodologies currently used for structured products. The issues raised concern the concept of the average probability of default under "normal" circumstances and the need for complementary approaches based on stress testing, taking into account the fat tails of the distribution curve of risks.
88. CESR would recommend that CRAs reconsider their approach to publishing methodologies to give investors access to information on key model assumptions when using ratings in their investment decisions. The potential impact that changes to these assumptions and correlations have on the ratings themselves should also be highlighted.
89. CESR believes the provision of information on the weightings of key parameters and correlations underlying structured finance ratings would assist investors in making informed use of these ratings in their risk assessment procedures. Information on the level of stress testing carried out during the rating process, to address concerns over tail risks would also allow investors to make better use of structured finance ratings in their investment decisions.

90. Do you agree with CESR's view that although there has been improvement in transparency of methodologies, the accessibility and content of this information for complex structured finance products requires further improvement in particular so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings?

91. The CRAs indicate that they review their methodologies on a regular basis, either on a yearly basis or in the event that the performance is outside of expected parameters for a particular asset class.

92. When rating agencies revise their methodologies for the rating of a particular asset class of structured finance they do not necessarily review all relevant existing rated securities against this methodology. The CRAs highlighted the fact that often these securities will be behaving as was expected at issuance and therefore reviewing these ratings against the new methodology would not be appropriate. Past-issuances would be reviewed against the new methodology if they were performing outside of expected parameters.
93. CESR found that whilst methodologies were freely available it proved difficult to track which evolution of the particular methodology had been used to rate/review specific issuances. This clearly could pose a problem to market participants trying to assess what value to place on a particular rating.
94. According to some commentators, as the massive downgrades which occurred in July, August and October coincided with the announcement of changes to rating methodology, it was not clear to investors if the downgrades resulted from the changes to methodologies or to the credit quality of the underlying assets, or both.
95. CESR believes that the CRAs should highlight clearly to investors which particular methodology a rating for a structured finance product is based on. One way in which this might be achieved is a clear labelling of ratings to indicate against which version of a methodology they were based on, including a link to the specific model.
96. CESR believes that the CRAs should be clear as to whether a change in methodology or performance in underlying asset pools has led to a rating review.

97. Do you agree that there needs to be greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as rating reviews?

98. There is often very little public data available on the performance of the underlying assets in structured finance products, this combined with the often heterogeneous nature of these products makes comparable assessment of these products by investors more problematic. Some organisations within the EU have highlighted initiatives they have begun to improve the level of standardisation and public disclosure of data for securitised products which CESR views as a positive step.
99. CESR believes there could be a great deal of benefit to the market if a greater level of public and standardised information could be generated to aid market participants in reaching their investment decisions.

100. Do you agree that there needs to be greater public and standardised information on structured products in the EU? How would this best be achieved?

III. 2. Monitoring

101. Monitoring timetables for structured finance products, such as RMBS, are typically driven by the regularity at which data is received on the underlying collateral pools – typically monthly or quarterly. This data is assessed automatically for each monitored transaction to check that predefined performance triggers have not been breached. In the event that these triggers are breached the rating is put under formal review. Ratings are also subject to a formal annual review.



102. CESR has been asked to comment on the value of CRAs producing periodic public reviews of structured finance ratings to some contractual deadline. This would likely have significant cost implications for the market as the cost of maintaining these ratings will increase. These public reviews would also lead to a large increase in the volume of information being published by the CRAs, which might add a little value in terms of individual product transparency but would likely prove detrimental to overall transparency.

103. Given the nature of the automatic monitoring already carried out on structured finance products CESR does not believe that having contractually determined public reviews would add value to the monitoring process. There would likely be high levels of cost associated with such measures and a possible negative impact on market transparency as a whole.

104. Do you agree with CESR that contractually set public announcements on structured finance performance would not add sufficient value to the market to justify the cost and possible saturation of the market with non-material information?

105. Typically, on an on-going basis fewer resources are dedicated to monitoring ratings than to carrying out initial ratings for two key reasons. Firstly, as indicated above, much of the initial monitoring of these transactions is carried out automatically against data performance criteria. Deals will be assigned for specific review by an analyst only if they do not perform as expected. The number of transactions a surveillance analyst is assigned will also depend on the asset class and complexity of the transactions being monitored. Secondly, as the analytical work on the particular deal structure and legal framework has already been carried out the rating review work should prove to take less analyst time.

106. The nature of structured finance products means that a deterioration in credit quality across an asset class can lead to a large number of ratings requiring review within a short period of time, with the possibility of further impact on products that are another stage along the securitisation chain from the underlying asset (CDOs of RMBS for example). This means that the resource required to process rating reviews may spike, with much greater staff and processing time required at certain periods to allow for rating reviews to be completed in a timely manner.

107. In the event that a CRA determines that an asset class is behaving outside of expectations they will review their methodology, reassessing specific ratings, or groups of ratings, where they evaluate the underlying assets are performing outside initial expectations. This can place a significant strain on analyst and committee resources in terms of processing a large number of rating reviews concurrently.

108. Although the CRAs have made concerted efforts to increase their resourcing for the surveillance of structured finance transactions since last summer, including the establishment of specific monitoring teams for certain assets and products, they had traditionally not allocated specific resource to this activity for some asset classes of structured finance business.

109. In their responses to CESR's questions the CRAs indicated that there was no conflict for analysts and committee resource between that dedicated to new issuances and that focused on reviewing ratings – either against new methodologies or due to a decline in asset performance. CESR remains concerned about the ability of CRAs to react appropriately to widespread credit deterioration in particular asset class performance which requires them to review large numbers of ratings in a short time period.



110. The establishment of dedicated monitoring teams is a positive step in allowing CRAs to take prompt rating action. However, CESR recommends that the CRAs continue to evaluate their internal processes to ensure they maintain the operational flexibility to allow them to dedicate necessary resource to reviewing outstanding ratings, when necessary, to ensure punctual action is taken. This is a particular area of concern for CESR and will be under greater focus in the future.

111. CESR recommends that the IOSCO Code should be updated to highlight the importance of allocating sufficient resource to the monitoring and review of existing ratings.

112. Do you agree that the monitoring of structured finance products presents significant challenges, and therefore should be a specific area of oversight going forward? Are there any particular steps that CRAs should take to ensure the timely monitoring of complex transactions?

III. 3. Human Resources

113. Concerns have been raised that the levels of staffing, both in terms of numbers and experience, at the CRAs was inadequate to effectively and accurately rate the volume and complexity of structured finance deals that warranted review in the second half of 2007. There is also concern that staff turnover was particularly high leading to ratings being assigned to inexperienced analysts.

114. The lack of comparability of human resources information provided to CESR by the CRAs and the inability of the CRAs to provide this information in the granularity that CESR requested has made it hard to draw detailed conclusions on the level of staff resource and experience growth over recent years. The same can also be said for the figures provided on staff turnover.

115. Although it is understandable that the CRAs will not follow the same method of resource monitoring and will have their own internal staff seniority scales CESR is concerned over the inability of the CRAs to provide information that would allow a more detailed analysis of their staffing trends, especially given the importance of human capital to their business model.

116. CESR would expect that rating agencies should have sufficiently advanced human resource management processes that they are in a position to provide key trends in staffing, employee development and turnover levels. The fact that they did not provide this information is an area of concern.

117. CESR would welcome further information from the CRAs to allow a more detailed analysis of their resourcing trends in its final report.

118. Do you believe that the CRAs have maintained sufficient human resource, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business?

119. Looking at the evolution of educational and professional experience requirements, it is noticeable that most agencies indicate that they have not changed their educational and experience level request over the past 10 years despite the increased sophistication of structured finance products and the growing importance of complex quantitative models in the credit assessment of those products. Only one agency points to the increased need for recruiting quantitative experts (financial engineers, statisticians, etc.) in the structured finance area.

120. Do you consider that the generally unaltered educational and professional requirements of CRAs' recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

121. Ratings are provided by committees not individual analysts and therefore there is an inherent check on the quality of the rating by other staff, including a senior and experienced employee. However, as mentioned above, concerns have been raised over the CRAs ability to retain sufficient numbers of experienced staff to maintain the quality of ratings. Currently there is very little public disclosure by the CRAs on this aspect of their organisation.

122. Concerns have been raised regarding the remuneration criteria for structured finance analysts. Although replies to the questionnaire indicated that analysts are compensated on the basis of their qualitative performance, the importance of a given client to a CRA is clearly known by staff members and may influence the rating process.

123. CESR suggests that the CRAs should consider the correct approach to ensuring the market has confidence that they are adequately resourced to provide accurate and high quality ratings. CESR believes this might be achieved via a greater level of transparency over their levels of human resource.

124. CESR would welcome more clarity about the remuneration policies for staff members involved in the rating process and would welcome measures taken to render remuneration decisions as independent as possible from influence.

125. Do you agree there is a need for greater transparency in terms of CRA resourcing?

126. Do you agree with CESR that more clarity and greater independence is required for analyst remuneration at the CRAs?

III.4. Conflicts of Interest

127. The nature of structured finance means that the rating process tends to involve a more iterative interaction between the CRAs and the issuer/arranger. One reason for this is that issuers of structured finance have more flexibility to alter the composition of their security than a corporate issuer would have to amend their finances. The CRAs highlighted that this interaction is beneficial in allowing them to gain a clear understanding of the proposed structure of the deal and produce a better informed rating. However, accusations have been levelled against the CRAs that their interaction with issuers/arrangers has become advisory in nature and presents a heightened risk that conflicts of interest will negatively impact the objectiveness of their rating opinions.

128. The CRAs indicated to CESR that they do not view their interaction with issuers/arrangers of structured finance products as advisory in nature. Typically, the issuer/arranger will bring a proposed structure to the CRA and the CRA will carry out its modelling and assessment of the underlying asset pool(s). This assessment will highlight the relative strengths and weaknesses of the structure, asset pool(s) and credit enhancement levels of the proposed product as well as providing an indicative rating. The issuer/arranger can then accept the initial rating proposed as a result of this assessment or choose to restructure the product in a number of ways to improve this rating. The CRAs stated that the way this is achieved, for example by altering the



underlying asset pool(s) or improving credit enhancement levels is left to the issuer/arranger and the CRA will perform a new assessment on any amended structure.

129. The CRAs indicated to CESR that they may provide feedback on credit enhancement levels, but only in-line with their publicly available methodologies and they did not provide advice on how to structure any deals. They do not therefore consider they provide an advisory service or believe their activity creates additional unmanageable conflicts of interest.

130. CESR believes that CRAs should ensure they are fully transparent with regard to the exact nature of their interaction with issuers/arrangers of structured finance products. They should also ensure they have strong policies and procedures in place to monitor and control this interaction and ensure it reflects their public position.

131. CESR feels that a clearer consensus over what constitutes advisory activity in the structured finance rating process would be beneficial to the market. This would assist in clarifying market and regulatory expectations for the CRAs with regard to this aspect of their business.

132. CESR would suggest that the IOSCO Code could be updated to provide greater clarity and act as a benchmark of acceptable practice for CRA interaction with issuers of structured finance products.

133. Do you see the level of interaction between the CRAs and issuers of structured finance products creating additional conflicts of interest for the CRAs to those outlined above? Do you believe that any of these conflicts are not being managed properly?

134. Do you agree that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers with regards to structure finance products and that there needs to be clearer definitions of acceptable practice?

135. The IOSCO Code requires that the CRAs separate their credit rating business and analysts from any other business, including consulting business, which may present a conflict of interest. This has led to some issues due to the lack of a definition of ancillary business and more particularly whether activities such as 'rating assessment services', 'pricing services' or other credit evaluation services, are ancillary or core rating activities. In its February 2007 consultation report IOSCO indicated that provision 1.14 of the Code explicitly contemplates CRAs providing such rating assessment type services, and explicitly contemplates that such services might typically fall under the ambit of a CRAs analytical staff.

136. CESR has, so far, been unable to completely satisfy itself over the segregation of rating and ancillary business at the CRAs due to the lack of a clear definition of what an ancillary business is. An important consideration here is the level of disclosure by the CRAs, as typically they have also no public definition of what constitutes an ancillary service in their organisation. The importance of this issue should not be underestimated in light of the questions that have arisen in the context of recent events related to asset valuation.

137. CESR is concerned on whether the CRAs definition of advisory services or ancillary services is distinct enough to handle inherent conflicts of interest. CESR believes that there needs to be greater clarity from the CRAs over what they consider to be ancillary business and what they consider core rating services. There are concerns



that the CRAs have not properly segregated or disclosed all services that pose a conflict of interest to their rating services which must be addressed.

138. Do you believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business?

139. The fee structures for structured finance products differ from traditional corporate fees and may become substantially larger depending on how complex and innovative the product is. The general structure for structured finance fees is to calculate a transaction fee determined as a percentage of the total issuance value (often with floors and ceilings), based on the anticipated complexity of the deal and the asset class of the product. Moreover, in case of complex and innovative structured finance transaction rating which require substantial additional time of analysis, fees can result higher than initially envisaged. This is then further increased by adding a fee for monitoring the transaction through its lifetime, either to be paid upfront or an agreed annual fee. The fees for structured products thus increase with the size and frequency of the issues rated. These transaction based fees are in fact 'success fees', as they are charged only if the deal goes through.

140. The CRAs highlighted that the increment in fees due to additional complexity of deals reflects the greater resource and time required to rate these products, however there remains some concern that the high fees earned and the fee model itself for structured finance ratings creates a material conflict of interest for rating agencies.

141. CESR notes that one of the characteristics of the fee model for structured products is that it is transaction based and depends on the completion of the rating process. This may lead to a conflict of interest specific to this sector.

142. Do you believe that the fee model used for structured finance products creates a conflict of interest for the CRAs? If yes, is this conflict of interest being managed appropriately by the CRAs?

143. CESR notes that public disclosure surrounding 'break-up' fees, when an arranger is charged for analytical work done by the CRA even if they choose not to proceed with the rating, is not always made by the CRAs.

144. Market responses to the CESR survey on structured finance indicate that participants were mostly satisfied with the level of fee disclosure in general but that there could be greater disclosure of structured finance fees. Respondents also highlighted the difficulty in comparing fee structures due to the complexity of deals and heterogeneous nature of the products.

145. CESR believes that the market would benefit from greater disclosure of all aspects of their structured finance fees and view transparency in this area as extremely important. CESR would particularly like to see greater disclosure around 'failed', or non-issued, ratings.

146. Do you agree with CESR that there needs to be greater disclosure of fee structures and practices with particular regard to structured finance ratings so as to mitigate potential conflicts of interests?



IV. CONCLUSIVE CONSIDERATIONS BY CESR

IV.1. Analysis of the changes to the CRAs codes of conduct since CESR's 2006 Report (CESR/06-545)

147. CESR provides below a preliminary assessment of the changes introduced by the CRAs in their code of conduct. CESR will provide a more in depth analysis in its forthcoming May report to the European Commission.

DBRS

148. DBRS new Code of Conduct adequately addresses several issues mentioned in CESR's last report to the European Commission (published in 2007, available through www.cesr-eu.org). The new and extended Code of Conduct consists of two parts: The Code of Conduct and "Additional policies and procedures to prevent the misuse of material non-public information, address conflicts of interest and ensure ethical business practices".

149. DBRS has edited most of the provisions of their Code of Conduct to clarify the wording and change misleading expressions. Furthermore, many minor differences identified by CESR's report were removed by DBRS.

150. The additional policies section contains previously independent documents which were highly linked with DBRS Code of Conduct, but not as easy accessible as the Code of Conduct itself. This section explains in detail several provisions and gives additional information.

151. It seems that DBRS has indeed tried to improve the implementation of the IOSCO Code by translating additional provisions into their own policies and procedures published in their Code of Conduct.

S&P

152. Rating Services' new Code of conduct adequately addresses one of the issues mentioned in CESR's last report to the European Commission. The new Code of Conduct differs in a new wording of provision 1.15. All other provisions did not change at all. S&P rather explain why they believe that the other two provisions mentioned in CESR's report do not need any change. Section 6 of Rating Services Code of Conduct states that "there are two areas in which the provisions of the Code differ from the provisions of the IOSCO Code: (i) Ratings Services operation and legal separation and (ii) the rating process for an unsolicited rating. Notwithstanding these differences, Ratings Services believes that the independence, integrity, credibility and objectivity of the rating and surveillance processes is not affected and, therefore, the IOSCO Code's essential purpose will be achieved."

Moody's Investors Services

153. Moody's published in October 2007 a revised Code of Conduct which demonstrates improvements in two areas. The first is that it provides for the separation of credit rating analysts both operationally and legally from the remaining services; nonetheless they have chosen to consider ancillary services as non-credit rating related without describing exactly what they are. The second area relates to the participation of credit analysts in fees discussions with issuers whom they rate. This provision has been



modified to exclude any exception to the IOSCO Code thereby paving the way for full compliance.

154. The provision in Moody's Code concerning the designation of unsolicited ratings remains essentially the same.

Fitch Ratings

155. The Code of Conduct that is published on Fitch's website as of the end of 2007 is that dated April 2005. The CESR Report of 2006 indicated that the Fitch Code was not fully compliant with the IOSCO Code in three domains. Fitch's letter to CESR dated May 10, 2007 indicates, however, that they believe that their Code is in compliance with the IOSCO with the exception of one point regarding the participation of analysts in fee discussion which they maintain is needed in certain circumstances. Thus there is no indication on their part of the intention to make any changes to their Code.

IV.2. The Regulatory Environment and Concluding Remarks

156. One of the key purposes of this paper is to consult with industry over the advice CESR intends to provide to the EU Commission on to the effectiveness of the current self-regulatory framework within the EU and specifically whether any policy changes merit consideration. Since the March 2005 CESR report advising the EU Commission on possible measures concerning rating agencies,⁶ the EU has chosen to adopt a "wait and see approach" to allow an evaluation of the impact of the IOSCO Code on the industry.

157. CESR has considered the perceived costs and benefits of the current regulatory framework, which involves an annual report by CESR of CRA self-regulation with the IOSCO Code of Conduct, and compares it to the likely costs and benefits of a regulatory regime. We do not define structures of possible regulation at this stage which means that respondents should consider the further benefits and costs that might emerge through specific regulatory structures.

The Current Self-Regulatory Regime

158. CRAs already face significant incentives to maintain the highest standards, because they rely heavily on their reputation for producing accurate and objective ratings. The current regulatory regime relies on market forces to drive compliance with the IOSCO Code. In general market respondents to CESR's survey were supportive of the impact the IOSCO Code had had on the activities of the CRAs since it was published. CESR has also seen some indications that the CRAs are responding in a concerted manner to market and regulatory concerns regarding their role in the structured finance sector, but this is currently not enough. It also needs to be supported by prompt and firm commitments for improvement of the rating industry. CESR can conclude that the IOSCO Code covers -though currently not in a completely satisfactory way- many of the areas of concern in the structured finance area and that the CRAs are largely compliant with the Code.

159. As covered earlier in this paper the IOSCO Code is currently being reviewed to make it more robust in dealing with the specific challenges of structured finance and clarifying provisions where CESR, the CRAs and other market participants have indicated more clarity is required..

⁶ CESR/05-139b



160. The table below highlights the areas of particular current concern and the areas of the original IOSCO Code that holds provisions to improve conduct of business in this area.

Areas of concern	Sections in the IOSCO Code
Transparency	1.10, 2.7, 2.8, 3.1-3.10, 3.16, 4.1
Monitoring	1.9, 3.5, 3.6
Human Resources	1.4, 1.7, 1.8
Conflicts of Interests	2.1-2.16, 3.12

161. When reviewing the current regulatory regime we can highlight the following key features as significant benefits:

- A. It relies on market forces to drive and enforce compliance, whereby the flexibility and innovation within financial markets are not perceived to be constrained by rules and regulations, which fits closely with the international nature of the credit markets.
- B. The regime does not provide for 'official' recognition that could exacerbate the over-reliance on credit ratings that has been a recognised feature of the market.
- C. It avoids the obvious legislative and implementation costs.

162. Set against the benefits of the current regime we can point to the following negative features:

- A. Regulators have no investigative powers to determine substantial CRA compliance with the IOSCO Code.
- B. The current regime does not provide regulators with the ability to enforce compliance with the IOSCO Code and relies fully on market discipline. There can also be a difference in viewpoint between regulators and CRAs on the intention and meaning of certain IOSCO Code provisions, placing even greater reliance on market judgement.
- C. Given the inclusion of ratings in the banking regulatory environment (Basel II), market forces may not be as effective as an incentive for CRA compliance with the IOSCO Code.
- D. Self regulation has in its nature limitations if CRAs act in a market with oligopoly features.

163. A current feature of the credit rating market is the lack of an industry body to represent the CRAs in their relations with regulators and market participants over key points of concern. The presence of such a body would provide a great deal of benefit to the interaction between regulators and the CRA community and would be likely to improve the effectiveness of the current regime. Conversely, the lack of such a body might be considered to be hindering the self-regulatory system. Given oligopolistic features of the credit rating industry there are obviously anti-trust issues that would need to be overcome but these problems do not appear to be insurmountable. CESR would view the creation of a body that allowed regulatory concerns to be dealt with a degree of coordination as a real benefit.

164. Do you agree with CESR's view of the benefits and costs of the current regime?

An EU Regulatory Regime

165. A number of possible frameworks have been suggested for a more formal oversight regime for CRAs within the EU, varying from a 'light' recognition process based on



some code of conduct, possibly the IOSCO Code, through to a 'strong' regime including authorisation or recognition requirements for EU activity. There is also the possibility of integrating some form of oversight powers into pre-existing EU financial regulations. This paper does not differentiate between these options at the current time but instead highlights the benefits and costs CESR perceives any regulatory regime would create.

166. The main benefits of introducing a regulatory regime can be considered to be:
- A. Powers to investigate CRAs compliance with whatever rules and/or principles of the regime particularly on issues which at the moment are perceived as not effectively dealt by the IOSCO Code.
 - B. Enforcement of CRA compliance with the rules and/or principles of the regime.
 - C. The regulatory regime would provide greater incentive for the CRAs to be more diligent and work to avoid future failings in the ratings process.
 - D. Some EU states have given formal status to CRAs under national legislation – a regulatory regime could lead to a coherent approach being applied to the CRAs in aspects covered by individual country legislation currently.
167. Set against the benefits of a regulatory system we must consider the following costs:
- A. Any regime that recognises or authorises CRAs may have a negative impact in how ratings are perceived in the market place and lead to greater over-reliance on these opinions.
 - B. Market participants have in the past expressed concerns it may threaten rating credibility/independence.
 - C. Further integration of ratings into other regulatory regimes (i.e. the ECAIs' recognition system under the Capital Requirements Directive) may have adverse effects on the use of ratings by market participants and would require combining the objectives of securities regulation with those of the other regulatory regimes.
 - D. There is a risk that a regulatory system could be inflexible and have a negative affect on market innovation.
168. As mentioned above market participants have so far indicated a preference for the current system.
169. It must be noted that the IOSCO Code has been in place since December 2004 and did not prevent the issues which emerged with ratings of US subprime backed securities. Respondents should consider whether this highlights a failure of the current regime that could/would have been prevented if a formal regulatory regime was in place.

170. Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

Conclusion

171. The events of last year and the on-going financial market impact means that we must re-evaluate our approach to oversight of the global financial system and, in this consultation, CRAs in particular. Whilst areas where CESR believes improvement is necessary are highlighted in the earlier sections of this paper, this does not necessarily mean that a regulatory regime is required. There are valid arguments for the current self-regulatory regime to be maintained just as there are arguments for the introduction of some form of regulatory regime. CESR will be providing advice on whether regulation is necessary or desirable to the EU Commission in its final report.

172. Regulation should be considered when there is a clear market failure that can be addressed through regulatory means without creating disproportionate negative impacts. CESR is still considering whether the issues presented in the credit rating industry would be best dealt with via a formal EU regulatory system due to the possible negative impacts on the market or by maintaining the current regime (with further development of the IOSCO Code), which does not provide any specific oversight or enforcement powers.
173. In the March 2005 CESR report no conclusion was reached about the possible implications of regulation on competition and innovation in the credit rating industry. Some respondents to the last call for evidence on this subject in July 2004 believed there would be negative repercussions in this area. However, others suggested regulation may actually provide smaller CRAs with greater market acceptance. CESR decided that financial regulation is rarely used in dealing with competitive issues and therefore market dynamics could not be used to argue for or against regulation. That said respondents to this paper may hold particular views on this issue.
174. The IOSCO Code is being reviewed and CESR expects this will lead to the Code being more robust in how it covers many of the areas of concern that have been raised.
175. CESR also recognises that market's use of ratings has contributed to the current market problems and this should be an area of particular focus for authorities going forward. Although investors should expect the highest standards of behaviour from CRAs they must also be clear that the final responsibility for investment decisions and risk assessment is theirs. Ratings should be used one element of and not the sole basis for investment decisions.
176. However, CESR expects that the CRAs will need to take continued and concerted efforts to address the concerns of CESR, other international bodies and the markets as a whole. This is particularly true with regard to the transparency of their structured finance methodologies, monitoring of outstanding transactions and conflicts of interest.

177. Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation?



ANNEXES TO THE REPORT



ANNEX I

SUMMARY OF RESPONSES TO CESR QUESTIONNAIRE REGARDING THE RATING OF STRUCTURED FINANCE INSTRUMENTS (published in June 2007)

Responses were received from five credit rating agencies: Moody's, S&P, Fitch, DBRS and CPR. The individual replies from CPR have not been incorporated here below as the firm indicated that it does not engage in structured finance related activity. The full text of their reply is nonetheless available on the CESR website.

A) QUESTIONS ADDRESSED TO THE CREDIT RATING AGENCIES

Organisation

1. What proportion of your total rating revenue comes from Structured Finance related activity? (Information kept confidential at request of the CRAs)

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

DBRS does not engage in ancillary businesses. Although DBRS may provide an impact assessment of the effect on the rating of potential transactions or situations at an issuer's request, DBRS views this work as an extension of its existing relationship with the issuer and not as a separate business line.

Fitch offers no advisory services, and offers only one ancillary service: a CDS consensus pricing service – Valuspread – which is relevant to both structured finance and corporate finance products. While Valuspread is a division within the Derivative Fitch operations, the revenue derived from the sale of this product is not included within the structured finance rating revenues. If Fitch would include it, it would have represented less than 0.6% of its structured finance rating revenues.

Moody's Investor Services (MIS) does not offer any non-rating “ex post” services related to structured finance products.⁷

S&P Ratings Services does offer services related to structured finance products in addition to credit ratings, such as, for example, models allowing market participants to evaluate and optimise potential securitisation structures with the same tools used by S&P Ratings Services' analysts – and products providing an insight into S&P Ratings Services' surveillance process in relation to certain transactions.

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

DBRS has a standard set of up-front and surveillance fees that are shared with clients across products and regions. Generally, in Structured Finance these fees are charged on a per transaction basis and in certain cases there is an initial set up fee for larger program type ratings as well as transaction and surveillance fees. In Corporate Finance, in particular in

⁷ As discussed in the MIS Report, MIS provides general credit training courses, some of which cover structured finance. Although we classify these courses as non-rating services, they are not specific ex-post services of the type we believe are referenced in this question.



the Financial Institutions Group, first time issuers are charged a fee and each rated entity is charged an annual rating fee.

Fees for corporate ratings and structured finance ratings are charged on a similar basis by Fitch. The fees charged for corporate ratings can be structured in a variety of ways, typically involving:

A fixed-rate recurring base fee for an issuer rating;

A once-only transaction fee based on a percentage (typically several hundredths of one per cent – that is, basis points) of the nominal value of a debt issue which may be subject to a cap in a given year for a single issuer; or

A combination of the two (i.e. a recurring or once-only fee that covers both issuer and issue ratings).

Given that in structured finance Fitch rates the issuance, rather than the issuer, fees are based on a subset of the above approach. Fees are determined by multiplying a specified number of basis points by the transaction size, subject to a floor (for small transactions) and a cap (for large transactions). The number of basis points is set by reference to a fee schedule which reflects the relative complexity of different asset classes and fees are uniformly charged across asset types. In many cases Fitch also charges surveillance fees, either on an upfront or ongoing basis, to cover the cost of monitoring the structured finance transactions over time. In all cases, as with corporate ratings, fees are not contingent on the level of any rating issued or the success of the issue. Fitch points out two differences between fee arrangements for corporate ratings and structured finance ratings. First, Fitch charges additional fees, post-closing of a structured finance transaction, if amendments and/or changes are made to or affect the rated securities which require the agency to undertake additional analysis. Secondly, Fitch may specify that a break-up fee is payable upon the decision that the issuance or sale of the structured finance securities to be rated will not proceed, or that a rating from Fitch is no longer requested, to compensate for the work already carried out.

Moody's Investor Services fees for rating structured finance transactions are based on the nominal issuance amount of the transaction, the applicable asset class and the anticipated complexity, as established in fee schedules. Fees for ongoing monitoring of ratings are generally fixed amounts, either payable annually or at the time of the initial rating. This is similar to the ways in which fees are determined for corporate and financial institutions ratings.

S&P fees in structured finance ratings are “transactional fees”. Fees charged are usually expressed in terms of “basis points” of the size of the securitisation issue. The quantum of the fee is determined on a transaction by transaction basis, but usually follows traditional price points. Fees may be charged which depart from traditional points in the case of new and innovative transactions requiring additional and high value added work. Fees are also often subject to “cap” arrangements, so that when transactions are over a certain agreed size the fee is capped at an agreed level. This is distinct from traditional pricing for corporate ratings where an annual fee is usually agreed and where the annual fee is expressed in basis points of the client's issuance that year.

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

Three rating agencies consider this question not applicable. Fitch states that Valuspreads fees are determined completely separately from any rating fee. Valuspread fees are based on



the number of CDS names that a subscriber wants priced on a daily basis, subject to a volume discount.

Fees for services related to structured finance products which Ratings Service offers in addition to credit ratings, are determined separately from any fees related to credit ratings.

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

DBRS does not engage in any ancillary businesses. Analyst compensation for all DBRS analysts is determined based on DBRS compensation philosophy, market survey participation and market intelligence. Compensation consists of base, short term incentive and for select senior individuals, long term incentive, reflecting a mix of individual and company-wide performance.

All of Fitch's analytical staff are assessed and rewarded based on their analytical performance and on the overall financial performance of Fitch. Remuneration is set by reference to performance against objectives that are set at the beginning and, where appropriate, revised during the middle of each year. The only Fitch employees for whom pay levels are directly linked to revenues are some members of our subscriptions sales teams, which are subject to our Firewall Policy. These staff members are responsible for the marketing of subscriptions to both our research reports and related products, such as Valuspread.

Compensation of analysts at MIS consists of a base salary and an annual bonus, with senior-level analysts also eligible for grants of MCO equity. For Analysts below the Managing Director level, the annual bonus is based on MIS's overall financial performance and the qualitative performance of the individual Analyst. For Managing Directors, the annual bonus is based on MIS's overall financial performance as well as strategic objectives specific to individual Managing Directors, which can include areas such as rating group financial performance, rating quality initiatives, results of Issuer or investor surveys and development of new products.

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

Rating process

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

All agencies claim that the organisation of the process for assigning a rating is fundamentally the same for corporates and for structured finance products.

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

Nonetheless, structured finance vehicles tend to have 1) more easily definable cash flows arising from specific assets or contractual obligations, 2) a prescribed transaction life to which the rating speaks, 3) greater flexibility to adapt structural features of a transaction in order to achieve a desired outcome, and 4) limitations on their legal ability to deviate from the stated purpose of the transaction which could influence single steps in the rating process.



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

As part of the rating process, DBRS liaises with issuers and their agents, such as investment bankers or financial advisors, bond counsels, investors and in certain cases, other third parties that are participating in a Structured Finance transaction, such as a servicer.

From a policy perspective, DBRS are governed by an entity wide Code of Conduct that is supported by a broad range of policies, procedures and internal controls. They provide open access and ongoing communication and training to all staff regarding the Code of Conduct and its supporting policies and procedures.

For Fitch, the principal contacts at the initial stages of the rating process are with the originator, the issuer and/or the arranger. Fitch will also receive information and documentation from the transaction lawyers. The arranger often acts as the conduit between Fitch and the originator for information on the underlying assets and their historic performance. It may also act as a conduit for outside opinions from other experts, such as accountants where relevant. Fitch's own lawyers (internal and external) may discuss legal and structural aspects of the transaction with transaction counsel, to better understand the transaction and whether and how legal risks relevant to our credit analysis have been mitigated. However, in all cases, these reviews are not designed to supplant or replace the legal analysis performed by transaction counsel, and are instead undertaken simply to understand the legal analysis provided by advisors or experts, such as auditors, actuaries and consultants, we may also discuss these reports and information with such third parties to understand their impact on our credit analysis.

Clear guidance on how these relationships should be conducted is provided within our Code of Conduct and related policies.

MIS's primary contact is with the intermediary that arranges the transaction – the arranger – who sets up the structure, tranches the liabilities and markets the tranches. They may also deal with: one or more originators, who either originate the underlying assets in the course of their regular business activities or source them in the open market; the servicer, who collects payments and may track pool performance; the asset manager, who – in managed transactions – may assemble the initial pool and subsequently trades in and out of collateral assets; the trustee, who oversees cash distributions to investors and monitors compliance with transaction documentation; the financial guarantor, who may provide guarantees on principal and interest payments to, or sells credit default swaps on, particular tranches as part of its business model of underwriting high-grade credit risk; and the administrator of an Asset-Backed Commercial Paper (ABCP) conduit that funds several asset pools.

MIS has adopted policies and procedures to maintain objectivity and independence, and to protect the integrity of our credit ratings and rating process. The framework for these policies and procedures is set out in the MIS Code and the Moody's Corporation Code of Business Conduct ("the MCO Code") together with associated policies referred to in those Codes.

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

S&P Ratings Services' Code of Conduct and its policies regarding the ratings process apply to S&P Ratings Services in its entirety.



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

DBRS provides fee information to the issuing entity of each transaction. Fitch's fee letter, covering the specifics of the remuneration for a particular transaction is typically signed with the issuer or, in cases where the issuer does not yet exist with the arranger. MIS provides its rating application, which includes the fee schedule, to the signatory of the application. S&P let the originator who usually pays the fees, as well as the investment bank mandated to arrange the issuance be aware of the fee. The negotiation as to the quantum of that fee may take place directly with the originator or through the mandated investment bank.

9. Please describe any specificity regarding your policy of publication of ratings in the Structured Finance segment.

The dissemination of DBRS, Fitch, MIS, and S&P Ratings Services credit rating announcements is standardised across rating groups. Publications are available on company websites.

Furthermore, DBRS publishes pre-sale reports and rating reports, which typically provide in depth detail and analysis. DBRS makes full rating reports, industry studies, commentaries and securitisation servicer reports available to paying subscribers. Each rating report provides the rationale and criteria for the rating decision and an analysis including the strengths, challenges and key characteristics of the issuer.

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

All four rating agencies monitor their methods/methodologies on an ongoing basis and adapt methodologies to market developments.

DBRS has published methodologies for all the key products and transactions it rates and also publishes new criteria and methodologies for additional or new asset classes, structures and/or geographies. In terms of monitoring existing ratings subsequent to a methodology change, DBRS continues to identify transactions whose performance falls outside expectations. For these transactions, DBRS applies the updated methodology when determining a subsequent rating action.

Updates may be necessary to reflect changes in market practices regarding the origination of assets, to reflect Fitch's revised views on the risks inherent in an asset class or simply to implement a new, more sophisticated, rating methodology. Existing transactions are reviewed according to the criteria under which they were originally rated. Thus, only in very rare circumstances will a change in criteria, by itself, change a rating. Methodologies are also informed by developments in the broader economy or specific sectors. While such developments may not lead to a change in Fitch's over-arching methodologies, they may lead, for example, to placing greater weight on one particular factor as opposed to another.

There have also been a small number of changes to existing methodologies, such as changes to asset correlation assumptions for collateralized debt obligations ("CDOs") backed by or referenced to structured instruments. In addition, in 2007, MIS revised its methodology for emerging market CDOs. In situations where MIS has modified an existing methodology, its monitoring teams apply the changes to outstanding ratings through the monitoring process.

Due to the continuing development of structured finance in new asset classes, new jurisdictions and new structures, S&P Ratings Services' structured finance criteria and assumptions are constantly evolving. In addition, S&P Ratings Services will adapt existing



criteria and assumptions if there has been a development in the market warranting a re-examination of such criteria and assumptions.

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

DBRS, Fitch, MIS, and S&P Ratings Services believe that the track record of their structured finance ratings supports the appropriateness of their models/methodologies and ratings processes.

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

DBRS and Fitch incorporate ratings from other rating agency's into own structured finance ratings, but the treatment of these incorporation depends on the judgment made by the three agencies regarding the quality and type of rating assigned by the other rating agency, industry sector, or NRSRO or ECAI status respectively, in order to evaluate the risks associated with this incorporation.

For those assets for which MIS has not already assigned a rating opinion, it nevertheless must perform analysis in order to form a judgment on the related credit risk. Consequently, MIS does not treat the ratings of other CRAs as its own because MIS does not believe ratings are "fungible". If ratings of the various CRAs were treated interchangeably, it would negatively impact the motivation and ability of rating agencies to differentiate among one another on the basis of improving credit analysis. Over time, this would degrade the quality of ratings and undermine investors' confidence in MIS's analysis. MIS sees a potential of misleading the market. If a rating agency were required to treat other CRA's views as interchangeable with its own views, even if such views were inconsistent, the rating agency would be compelled either to disseminate information that may mislead the market, because it would be required to adopt ratings with which it disagreed, or not to rate the security. This outcome is tantamount to quashing independent views, and it may also contravene the market abuse provisions of the Market Abuse Directive to the extent that dissemination of such information could give, or is likely to give, a false or misleading impression.⁸

In rating structured finance transactions, S&P Ratings Services may in its sole discretion take into account public ratings produced by another rating agency. S&P Ratings Services believes that, in evaluating the creditworthiness of structured products, it must understand the credit quality of all the underlying assets which are typically the sole source of payment of the structure's debt and there are several ways to do this. Where the underlying assets have previously been rated by S&P Ratings Services, then those existing ratings will be used in the analysis of the securities of the overall structure. However, if the underlying assets have not already been rated by S&P Ratings Services, there are several alternatives. For example, S&P Ratings Services may perform an analysis of the underlying assets without assigning a rating on them or may incorporate other information about the credit quality of those assets (including ratings by other rating agencies). As result of the above risk, S&P Ratings Services is reluctant to use other rating agencies' ratings except as a starting point of a small portion of the pool of underlying assets in certain types of transactions. However, to account for, among other matters, the analytical and surveillance practice differences amongst rating agencies' ratings except as a starting point for a small portion of the pool of

⁸ Article 1 (2) of the Market Abuse Directive states that:

"Market manipulation" shall mean:

(c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading...."



underlying assets in certain types of transactions. However, to account for, among other matters, the analytical and surveillance practice differences amongst rating agencies – and the possibility that these assets could be downgraded by the other rating agencies at any time without notice to S&P Ratings Services – S&P Ratings Services reserves the right to discount the ratings of other agencies when incorporating them into its independent analysis.

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

Each outstanding rating, with the exception of point-in-time ratings, is monitored frequently with the purpose of identifying transactions that are performing outside of DBRS's expectations. As part of the rating process, the issuer is responsible for sending performance reports to DBRS, usually with the same frequency as the payment of the rated debt, monthly, quarterly or semi-annually. Upon receipt of the reports, DBRS surveillance analysts compare a transaction's current performance against DBRS's performance expectations, past performance, with the goal of performing trend analysis, and all structural performance-based tests, as dictated by the transaction's legal documents. Exogenous factors are also considered. DBRS maintains an internal Watch List, which is a documented list of transactions that are prioritized for review and more rigorous monitoring

The Fitch surveillance process is split into two parts:

- Ongoing review of monthly/quarterly information by the performance analyst; and
- A full review by a rating committee periodically, the frequency of which depends on the results of the ongoing review process under (a).

In terms of the ongoing review for structured finance transactions, Fitch receives performance data on key parameters in a format determined at the close of the transaction, and reviews these against base case forecasts, which are based on historic performance. For each of the key parameters, Fitch sets 'soft triggers' – essentially internal markers which, if exceeded, trigger a need for further action. For other products, the review process is automated such that changes in the quality of the underlying portfolio or any counterparty to the transaction is flagged, with a report highlighting the magnitude of the credit change produced soon after the data is received.

In structured finance, MIS generally has dedicated monitoring teams for specific asset classes, which are outside of the teams that rate securities on issuance. In the monitoring of outstanding ratings, the surveillance team generally receives updated asset performance data on a monthly basis. Using this data and other information, MIS assess the database of transactions they have rated and flag potential rating "outliers" – securities whose asset performance indicates that the current rating may not be consistent with the current estimated risk of loss on the security. Once a specific rating is flagged, a surveillance Analyst will further analyse the status of the transaction and consider whether a rating change should be considered. If appropriate, a rating committee will be convened to consider the relevant information and determine whether a rating action (i.e. upgrade, downgrade, or review for upgrade or downgrade) should be taken.

Asset Class	Inputs
ABS (1) - general ¹⁵	<ul style="list-style-type: none"> Regular reports and information from servicers and trustees of transactions The ratings of counterparties or credit support providers Macro-economic factors which are deemed to impact the performance of the securitized assets.
ABCP (2)	<ul style="list-style-type: none"> Monitoring reports from conduit administrator with asset information (size, type, geography, seller name, etc.)
Derivatives (3)	<ul style="list-style-type: none"> Trustee, manager and servicer reports Collateral ratings Swap counterparty ratings “Macro” information: e.g. relevant indices, sovereign rating history and national statistics on performance of small companies among other things.

(1) Asset Backed Securities (2) Asset Backed Commercial Paper (3) CDOs and Repackaged Securities

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

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

DBRS 1 to 3 years corporate finance ratings tend to move with more frequency than Structured Finance. Structured Finance Ratings tend to be more in favour of upgrades than downgrades.

Rating activity across Fitch-rated global corporate and structured finance issues has been fairly similar. However, rating changes across structured finance as a whole have been skewed to the upside while rating migrations has on average been more evenly distributed across Fitch’s universe of global corporate ratings. With respect to the magnitude of rating changes, there have been more instances of multi-notch rating changes in structured relative to corporate finance.

MIS rating changes occur more frequently for corporate ratings than for structured ratings. However, the average number of notches changed per rating action in the structured finance sector is larger than the average number of notches changed in the corporate sector.

Rating volatility at S&P was higher among corporate ratings than among structured finance securities during 2006, as demonstrated by lower stability rates in corporate ratings. Both downgrades and upgrades were higher in the corporate context.

15. Is the internal process for amending a Structured Finance rating similar to the one for amending a corporate rating?

⁹ The broad term “asset backed securities” refers to bonds or notes that are based on pools of assets, or collateralized by the cash flows from a specified pool of underlying assets. These asset pools can be made of any type of receivable from the common, like credit card payments, auto loans, and mortgages, or esoteric cash flows such as aircraft leases. Two of the more common ABS sub-sectors include RMBS and commercial mortgage backed securities (CMBS).



Yes. The internal process for amending ratings of different types is similar in all rating agencies, as both types of ratings are monitored on a frequent basis and rating actions must be taken by a Rating Committee, prior to being disclosed to the market.

Potential conflicts of interest

16. Do you think that the iterative process inherent in rating Structured Finance transactions may involve additional conflicts of interest compared to those arising in corporate ratings?

All rating agencies recognize that there is typically more interaction with the relevant parties in rating structured finance transactions, however all agencies do not believe that this additional contact results in additional conflicts of interest.

If yes, how your firm is organised and what additional measures do you have in place to manage those potential conflicts?

Not applicable.

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

No additional comments are given from rating agencies, but reference to the answer given in question 2.



Annex II

Additional request for information sent by CESR to the 4 CRAs on 14 November 2007

Transparency of methodology

1. **Publication of methodologies and assumptions:**
 - a. Is there a section on your website devoted to the publication of your methodologies?
 - b. Do you provide explanations of the methodologies applied to the different categories of ratings for each asset class (e.g. RMBS, CDO, etc) separately by region?
 - c. Do you provide the full method applied to each category of rating for each asset class (e.g. RMBS, CDO, etc.) separately by region?
 - d. Is all of the above information freely accessible or is part of it only available for subscribers?
2. **Publication of changes in methodologies and assumptions:** Are all changes/adjustments to your methodologies and assumptions **published** and, if yes, where exactly are they published?
 - a. Is there a special section on your website where changes made to criteria can be reviewed over time?
 - b. Do you publish reports that discuss the changes made to criteria?
 - c. Do you have press conferences to announce and explain those changes?
3. Do you provide links/references to those publications mentioned in question 2 in the respective rating change reports (i.e. the announcement of a change would let the reader know where to find the related methodology)?
4. If changes have been made to your methodology for a particular product type (say US sub-prime RMBS) but previous issues have not been reviewed against this methodology how do you ensure this is clear to the marketplace? If the previous issues were being reviewed how would this be made public?
5. Is publishing the methods you use enough to meet the requirements of the IOSCO Code and ensure sufficient transparency or do you see further possibilities for **improving transparency/the understanding of**
 - a. your ratings?
 - b. your rating process?
6. What steps does your firm take, if any, to contribute to enhancing the financial education of investors or potential investors?
7. Do you take steps to clarify any limitations to your ratings, including what they are intended to cover, or the methodologies and the assumptions underpinning them? How do you do this?
8. Do you publish, and if so, where, your approach to the **use of confidential information** in rating of structured finance (SF) operations? Does it differ from that which you follow in “traditional” corporate rating?
9. Do you consult with industry as to what disclosure levels they would like to see for methodology and model assumptions?



Human Resources

10. Please provide us with the following information with regard to SF ratings and traditional ratings:
 - a. Exhibit 4, 8 and 13 of your NRSRO application form.
 - b. The internal definition of the existing classes/levels of employees in the CRA’s rating business: e.g. junior/mid/senior analysts, supervisors, committee analysts, lead analysts, etc? ¹⁰
 - c. Historical data for exhibit 8 (information on number of analysts/supervisors) covering the 1997-2006 period split by:
 - I. the staff levels identified in point (b) above.
 - II. Worldwide, EU and US based.
 - d. What are the minimal educational and professional requirements for the different levels of employees (as defined in b) within the analytical staff, and have these requirements varied over the past 10 years? If they varied, how did they vary?
 - e. The typical minimum number of years of experience according to levels of employees as defined in (b). Has this number evolved over the past 10 years? If so, how?
11. Please provide us with figures on the annual turnover of employees over the period 1997-2006, split per level (as defined in (1.b)), covering I) SF ratings and II) traditional ratings.
12. What are the risks presented by staff turnover to your ability to function effectively as a provider of accurate ratings and what steps do you take to mitigate these risks? Are these successful?
13. Has it become harder to fill vacancies in structured finance ratings teams over the last 5 years? If yes, what has been done to ensure you continue to have sufficient resource and to ensure this does not affect the quality of your ratings?
14. Typically, what is the composition of a monitoring/rating team in terms the job profiles and job levels and does this differ from teams that monitor/rate corporate bonds?
15. Please provide us with information on the average number of deals and average number of transactions under surveillance per lead analyst by type of SF products in the following table format:

Type of product	Average number of deals per lead analyst in 2006 (primary rating) *	Average number of transactions under surveillance per lead analyst in 2006
RMBS		
CMBS		
CDO		
ABS		
(additional if necessary)...		
...		

* both deals that resulted in a final rating and deals that did not result in a final rating.

¹⁰ This question is designed to enable the CRA to answer the other questions based on its own human resources structuring method as different CRAs may have different human resources structures or seniority definitions (junior/senior, analyst/supervisor...).



16. What are the total annual wage costs in structured finance rating over the period 1997-2006?
17. Do you outsource part of the rating/surveillance process (e.g. data gathering, processing, modelling, etc.)? If yes:
 - a. Please describe in which part(s) of the rating/surveillance process you make use of outsourcing and to what extent.
 - b. What are the risks implied by such outsourcing and how do you tackle these?
 - c. Do you consider the (economic) gains of such outsourcing to exceed the risks?
Please motivate.

Monitoring of transactions

18. What drives the frequency of rating review for structured finance? Why is this frequency appropriate? Please outline the process that would lead to a rating being taken to review committee?
19. Would regular reviews and announcements on the appropriateness of structured finance ratings - possibly based on some contractual deadlines (i.e. on a regular (quarterly/semi-annual basis) - help in preventing mass downgrades, improve the appropriateness of existing ratings? If not, why?
20. What changes have you made in terms of the surveillance of ratings since the widespread RMBS and CDO downgrades earlier this year?
21. How is the appropriate portfolio size determined for structured finance monitoring analysts? Are there any internal procedures which dictate how many transactions a monitoring analyst should be responsible for?
22. Are the costs of monitoring structured finance transactions fully covered by the fees charged specifically for monitoring when the rating agreement is initially made? What are the main incentives for maintaining effective monitoring of ratings?
23. How is committee time dedicated to rating reviews versus that dedicated to new ratings determined, particularly for structured finance? Are there clear internal procedures on how committee time is prioritised?
24. Are the committee members reviewing a rating the same as those who approved the initial rating? Are there any internal procedures dictating the composition of the review committee?
25. Is there a team of macroeconomic analysts within your firm responsible for systematically analyzing macro data coming in and building macroeconomic forecasts on which analysts can rely for their modelling/monitoring of ratings? If not, would this be useful?
26. Please provide us with a breakdown of revenues from SF ratings for initial rating/surveillance. How is the relative size of each of these parts of the fee decided?

Methodology changes



27. What prompts a review of rating methodology? Is there a central team that reviews methodologies or is it dependant on individual business lines self-evaluating their models?
28. Have you made any changes to how you evaluate the appropriateness of your methodologies on an on-going basis in light of the RMBS and CDO downgrades of earlier this year?
29. When the methodology for a type of structured finance product (example being US sub-prime mortgage backed securities) is amended:
 - a. Do you automatically review all existing ratings against the new methodology and take rating action based on this review? If not, what is the rationale behind this?
 - b. How is the scope of the application of the change of methodology determined? In other words on what basis does your firm decide whether or not to apply a change to existing ratings or just to new issuances?
 - c. Please explain in detail how is the timing of rating action determined across all affected ratings?
30. Does your firm at any time make any overall review of the changes to methodologies made, for instance during one year, and their impact on ratings to assess trends for instance? Would this be made public?
31. Is there a risk of originators 'gaming the system' i.e. keeping requested data sets high whilst other valid indicators of asset quality decline? If yes, what mitigation have you put in place to reduce this risk?
32. Do you feel that your approach to the assessment of the quality of underlying asset data is appropriate? Are you considering any changes in this area (specially in light of the recent events in the US sub-prime mortgage market)?

Conflicts of Interest

33. When you rate a structured finance operation do you offer services such as impact assessment and/or models of evaluation or optimisation of the securitization structure? Can you quantify¹¹ the number of cases where these kinds of services were offered? Would these services be performed by the analyst who rates the final structure?
34. Is the analyst assigned to a certain structured finance rating deal allowed to give advice to the participants (before the rating is issued) about how to structure the deal in order to raise the rating? Is the analyst allowed to give feedback to the participants of a deal if the initial rating does not meet expectations? Are there limits to which elements of the deal can be addressed and to what extent (i.e. does the analyst provide suggested changes to the structure)? Is this covered in any internal policies? Is this interaction monitored by the agency?
35. Can factors such as greater complexity and/or innovative features in a structured finance deal lead to a higher than standard fee? If yes, please indicate how much

¹¹ E.g. in percentage of total structured finance ratings issued, or by giving the indication “always”, “often”, “sometimes” or “never”.



these aspects can increase the initial level of the fees (as a percentage), how this increase is determined and who makes this decision.

36. Please provide us with data about your remuneration structures and those of your management hierarchy in your parent company.

Miscellaneous

37. Are you satisfied with the level of information received from servicers of European mortgage pools? Is this of a different quality, level of standardisation or frequency to information received in the US?
38. Are ratings across different asset classes similar in terms of pace and pattern of migration? Would some form of volatility indicator be possible, and appropriate for structured finance ratings?