



**ANNEX TO THE CALL TO CESR FOR TECHNICAL ADVICE ON POSSIBLE MEASURES
CONCERNING CREDIT RATING AGENCIES**

This annex summarises the main strands of work underway internationally on credit rating agencies and which CESR is requested to examine during the preparation of its technical advice to the Commission.

1. EUROPEAN PARLIAMENT

1.1 European Parliament Resolution on role and methods of rating agencies

On 10 February 2004, the European Parliament (EP) adopted a Resolution on the role and methods of rating agencies, following an own-initiative report from its Committee on Economic and Monetary Affairs (Rapporteur: MEP Katiforis).

Main features of the European Parliament resolution:

- Calls upon the Commission to undertake all necessary steps, including in particular a cost-benefit analysis of the effects on European capital markets, to assess the establishment of a competent European Registration Scheme under the auspices of the Committee of European Securities Regulators (CESR) for the registration of rating agencies in Europe, conducted on the basis of well-specified, publicly advertised criteria involving credibility, objectivity, independence, expertise of staff, adequate funding, the existence of proper procedures for identifying and dealing with conflicts of interest and transparency of operations;
- Calls upon the Commission to maintain close contact with other securities market regulators and the International Organisation of Securities Commissions (IOSCO) to ensure that any developments in this area are globally consistent;
- Calls on the Commission and CESR to establish and maintain close contact with the US authorities on the conduct and outcome of their investigation;
- Calls for promotion of rating agencies which take greater account of the specific characteristics and needs of small and medium-sized enterprises;
- Regards specialisation of some rating agencies (in specific economic sectors or specific attributes of rated issuers) should not constitute any obstacle to their being treated on a level playing field with other rating agencies by regulatory authorities;
- Asks the Commission, CESR and the European Banking Committee to take into

account the conclusions of the Financial Stability Forum, the IOSCO report on credit rating agencies and any reform of rating agency approval by the US SEC;

- Considers that rating agencies have public good objectives and should, therefore, report on their yearly activities and in particular on the financing of their rating activities;
- Favours inviting agencies to discuss setting up a voluntary industry body that would determine best practice, encourage training and provide a disputes and arbitration procedure for issuers or investors that felt aggrieved by the process leading up to an agency's decision;
- Wishes to oblige rating agencies to make public all their unsolicited ratings and to explain upon request any substantial difference between any unsolicited and subsequently solicited rating on the same debt or rated entity;
- Rejects the idea of regulating of content and opinions expressed by the agencies, stressing the need of agencies' independence from political or business influence, but does not reject regulation of process (whilst recognising the difficulty of drawing such a distinction);
- Wants issuers and debtors (that choose to be rated) to provide all relevant information on a permanent basis to rating agencies;
- Wants agencies to be transparent with regard to their methods, models and fees;
- Wants ratings users to disclose any rating triggers included in loan agreements in order to preserve the stability of markets;
- Asks the EU's competition authorities to consider any evidence of oligopoly;
- Calls on the Commission to submit, by 31 July 2005, its assessment of the need for appropriate legislative proposals to deal with the issues in the Parliament's Resolution and to ensure that any provisions adopted are consistent with the review of capital requirements for banks and investment firms (Basel II).

1.2 EP resolution on corporate governance and supervision of financial services – the Parmalat case

On 12 February 2004, the EP adopted a Resolution on corporate governance and supervision of financial services – the Parmalat case, following an own-initiative report.

In this resolution, the EP expressed the concern that among others, credit rating agencies had not raised the slightest suspicion that funds were being embezzled.

2. INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

2.1 September 2003 report (including a ‘Statement of Principles’)

In September 2003, IOSCO released a report from its Technical Committee on the activities of credit rating agencies. The final section of this report consists of a Statement of Principles. This Statement of Principles covers the manner in which credit rating agencies activities should be conducted in order to reinforce the integrity of the rating process and to assist credit rating agencies in providing investors with informed and independent opinions.

The Chairman of the Task Force in charge of this Statement of Principles, Commissioner Roel Campos from the US Securities and Exchange Commission (SEC), stated in particular that these high-level principles – which focus more on objectives than methods or standards – will prove useful in all IOSCO jurisdictions, regardless of the legal systems and policy choices of the different IOSCO members.

The Statement makes clear that the manner in which these principles are given effect will depend upon local market circumstances and on each jurisdiction’s legal system. In some cases, the principles may be best implemented through internal mechanisms within the credit rating agencies themselves and promoted by borrowers, lenders and other market participants. Alternatively, depending on the circumstances, the principles could be given effect through regulatory requirements.

As a result, according to the Statement, mechanisms for implementing the principles may take the form of any combination of government regulation, regulation imposed by non-government statutory regulators, industry codes and internal rating agency policies and procedures.

The Technical Committee of IOSCO proposed to await future consideration of these alternatives in the major jurisdictions and take account of preferences of other sector supervisors before considering its preferred method of implementation.

The Technical Committee proposed to review these developments within 18 months.

Main features of the Statement of Principles:

- Rating agencies should endeavour to issue opinions that help reduce the asymmetry of information between borrowers, lenders and other market participants (eg through rigorous methodologies, competent personnel);
- Rating decisions should be free from any political or economic pressure or conflict of interest (including ownership structure, business activities and employees' interests). Rating agencies should avoid circumstances that might compromise the independence and objectivity of credit rating activities, or they should manage and disclose them;
- Credit rating agencies should make disclosure and transparency an objective in their rating activities (eg transparency of procedures and methodologies, or whether a rating is unsolicited);
- Inside information should be maintained in confidence, through confidentiality agreements or mutual understandings.

2.2 Forthcoming IOSCO Code of Conduct for credit rating agencies (planned completion date: September 2004)

Following IOSCO's first initiative outlined above, some securities regulators and some rating agencies suggested that more specific and detailed guidance on how the principles laid down in the Statement of Principles should be implemented in practice would be useful. Therefore, IOSCO decided to develop a Code of Conduct for credit rating agencies, irrespective of legal and regulatory structures.

In May 2004, Commissioner Roel Campos from the US SEC and Chairman of the Task Force on this issue, stated that this Code of Conduct would be designed to address concerns surrounding how to ensure quality and integrity of rating processes, potential conflicts of interest, and comparability of 'track records' from different agencies by investors.

The Task Force plans to seek comment from the credit rating agency industry and the Basel Committee on Banking Supervision in June 2004. It will seek broader comment from the public, as well as interested governments, in July or August 2004.

The Task Force plans to complete the Code of Conduct by autumn 2004.

3. UNITED STATES SECURITIES AND EXCHANGE COMMISSION (SEC)

Since 1975, the SEC has relied on credit ratings from "market-recognised credible" rating agencies in order to distinguish between grades of creditworthiness in various regulations under the federal securities laws. These agencies are recognized as "nationally recognised statistical rating organisations" (NRSROs) by the SEC through the no-action letter process. There are currently four NRSROs: Moody's Investors Service, Inc; Fitch, Inc; Standard and Poor's, a division of The McGraw-Hill Companies, Inc; and Dominion Bond Rating Service Limited (DBRS).

The initial regulatory use of the term “NRSRO” was solely to provide a method for determining capital charges on different grades of debt securities under the SEC Net Capital Rule for brokers-dealers, Rule 15c3-1 under the Exchange Act.

3.1 SEC Report on the role and function of credit rating agencies (January 2003)

Following the Enron collapse, the SEC submitted to Congress in January 2003 its Report on the role and function of credit rating agencies in the operation of securities markets in response to the Congressional directive contained in Section 702 of the Sarbanes-Oxley Act of 2002.

The report was designed to address each of the topics identified in Section 702, including the role of credit rating agencies and their importance to the securities markets; impediments faced by credit rating agencies in performing that role; measures to improve information flow to the market from credit rating agencies; barriers to entry into the credit rating business; and conflicts of interest faced by credit rating agencies. The report addressed additional issues such as allegations of anti-competitive or unfair practices; the level of due diligence performed by credit rating agencies when taking rating actions; and the extent and manner of SEC oversight of credit rating agencies.

3.2 SEC Concept Release on rating agencies and the use of credit ratings under the federal securities laws (June 2003)

On 4 June 2003, the SEC issued a Concept Release, submitted for public comments until 28 July 2003. This work was considered by the SEC as part of their review of the role of credit rating agencies in the operation of securities markets.

The SEC was seeking comment on several issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under US federal securities law and, if so, the process of determining whose credit ratings should be used, as well as the level of oversight that should be applied to such credit rating agencies.

The underlying aim was to find the appropriate degree of regulatory oversight that should be applied to credit rating agencies: between completely ceasing use of the NRSRO designation and rating agencies oversight, and implementation of a much more pervasive regulatory regime for credit rating agencies.

Areas of questions presented by the SEC for public discussion:

- NRSRO designation: advisability and feasibility of eliminating the NRSRO designation from the SEC's rules; which possible alternatives;
- Criteria for NRSRO recognition: need to change existing criteria and which possible alternative criteria;
- Examination and oversight of NRSROs: level of examination and need for ongoing oversight;
- Conflicts of interest: means of managing potential conflicts;
- Alleged anti-competitive, abusive and unfair practices: means of preventing them;
- Information flow: need and means for improving the quality of information available to users of credit ratings.

Following the end of consultation in July 2003, the SEC decided to reflect further on the subject.

4. G8 DECLARATION ON 'FOSTERING GROWTH AND PROMOTING A RESPONSIBLE MARKET ECONOMY' (JUNE 2003)

In June 2003, during the G8 Evian summit, the G8 Declaration on 'Fostering Growth and Promoting a Responsible Economy' made reference to rating agencies.

Statement from the G8 document 'Fostering Growth and Promoting a Responsible Market Economy':

"Integrity, quality and accessibility are the cornerstones of reliable financial information. We call on all information providers – first and foremost companies and their auditors, as well as (...) rating agencies – to abide by these principles."

5. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

In April 2004, the governments of the 30 OECD countries approved a revised version of the OECD's Principles of Corporate Governance, adding new recommendations for good practice in corporate behaviour.

The initial Principles of Corporate Governance were adopted by OECD governments in 1999. It was decided that they should be revised in 2002, following a request from OECD governments for reinforcement of the Principles in response to then recent corporate scandals. A draft of the revised version was submitted to the public in January 2004.

These principles are non-binding, but they underpin the corporate governance component of the World Bank/IMF Reports on Standards and Codes (ROSC) and are part of the Twelve Key Standards for Sound Financial Systems named by the Financial Stability Forum.

In particular, the revised version calls on the corporate governance framework to be complemented by an effective approach that addresses and promotes the provision of analysis by rating agencies (among others) free from material conflicts of interest – identified under the form of provision of other services to the company, or of direct material interests in the company – that might compromise the integrity of their analysis. The preferred solution is to demand full disclosure of conflicts of interest and how the agency is choosing to manage them.

6. ASSOCIATION FRANÇAISE DES TRESORIERES D'ENTREPRISE (AFTE) – ASSOCIATION OF CORPORATE TREASURERS (ACT) – ASSOCIATION FOR FINANCIAL PROFESSIONALS (AFP)

6.1 Rating Agencies Survey by US AFP (November 2002)

In November 2002, the US Association of Financial Professionals, composed of 14 000 individual members working in the field of treasury and financial management, released a survey on rating agencies.

Main result of the AFP survey:

- 65% of corporate practitioners and 60% of financial industry service providers believe the SEC should clarify the procedures it uses for recognising rating agencies;
- 73% of corporate practitioners and 71% of financial industry service providers believe the SEC should periodically review the rating agencies it recognises;
- 56% of corporate practitioners and 63% of financial industry service providers believe that the recognition of additional rating agencies would improve ratings quality;
- 58% of corporate practitioners and 76% of financial industry service providers believe that the recognition of additional rating agencies would improve timeliness.

6.2 Code of Standard Practices for Participants in the Credit Rating Process (April 2004)

In April 2004, AFTE (from France), ACT (from the UK) and AFP (from the US) released an Exposure Draft of a “Code of Standard Practices for Participants in the Credit Rating Process”. The aim of this code is to improve investor and issuer confidence in credit rating agencies and the judgements they promulgate in their reports. This draft was submitted for public comment until 30 June 2004.

When releasing the code, the AFP President made clear that this code is not a replacement for appropriate regulatory action. He added: *“Investors and corporations alike continue to be frustrated by the rating process while they wait for the regulators to act. It is time for the appropriate bodies to act on regulatory improvements that will encourage competition and transparency in the rating agency process. Regulatory action, along with the effective implementation of the Code of Standard Practices, will improve the effectiveness of the credit rating process and efficiency of capital markets.”*

The code includes recommendations addressed to regulators, credit rating agencies and debt issuers. The code is made up of three sections:

- regulatory recommendations;
- recommendations for a rating agency code of standard practices; and
- recommendations for an issuer code of standard practices.

Main features of the joint AFTE/ACT/AFP Report:

➤ **Regulatory recommendations:**

- Credibility and reliability of ratings: no prescription of rating agencies methodology by regulators, but requirement that every rating agency documents and adheres to its chosen, published methodology; requirement to disclose the date of the last formal review and of the last ratings update;
- Transparency in the rating agency recognition process and removal of barriers to competition: transparent, simple, stringent but attainable criteria for recognition or approval of rating agencies;
- Improvement of on-going regulatory oversight of approved rating agencies: regular review of each recognised agency;
- Inside information flows: regulators should require rating agencies to document and implement policies and procedures to prevent the selective disclosure of inside information (in particular where rating agencies are part of a wider organisation that might benefit from inside information) and prohibit former rating agencies analysts from taking positions in securities markets or working as journalists;

➤ **Recommendations for a rating agency Code of Standard Practices:**

- Improvement of the transparency of the rating process: public disclosure of methodology and of changes in methodology; public disclosure of the definition and historical default rates of each rating symbol used; public disclosure of the qualification and sector coverage of the analyst concerned;
- Protection against conflicts of interest: ownership structure unlikely to create conflicts of interest; strong Chinese walls between rating analysts and agency staff responsible for raising revenue from solicited ratings; strong Chinese walls between rating analysts and staff involved in providing rating advisory services;
- Address the issue of unsolicited ratings: explicit mention of ‘solicited’ or ‘unsolicited’

nature of the rating; explicit mention of the participation of the issuer in the rating process; explicit mention of discussions with the issuer prior to the rating decision or of the use of non-public information to build the rating;

- Disclosure of the date when a rating was last updated: along with the date of the last full review with the issuer (not less than one year as a principle);
- Improvement of communication with issuers and other market participants: review by issuers of accuracy of reported information prior to public release; disclosure by the rating agency to the issuer of the key assumptions and fundamental analysis underlying the rating decision; right of appeal by the issuer, including to the rating committee or through an outlook from a new group of analysts; recording of information related to the issuer for a sufficient period;

➤ **Recommendations for an Issuer Code of Standard Practices:**

- Minimum list of information to provide to rating agencies: business strategy, legal and management structure and processes, business environment, risk management and financing, any material change in the financial situation;
- Full review between rating agency and issuer at least once a year;
- Information of rating agency by issuer ahead of launching any corporate actions;
- Fast answer to rating agency requests;
- No pre-emptive action to challenge or counter the release, during the period where rating agencies submit communications to the issuer prior to their public release;
- Not taking advantage of a delay in the release of a rating by making any debt issuance other than the refinancing of maturing short-term debt.