STANDARD & POOR'S RATINGS SERVICES

Toward a Global Regulatory Framework for Credit Ratings

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I. Overview and Summary

Our financial markets have changed radically in recent years, becoming more global, complex, and interdependent. Clearly, laws and regulations have to change as well, and world leaders are making good progress toward creating a new global financial architecture. The need for change includes the regulatory framework for credit rating agencies in the U.S., Europe, Asia, and the rest of the world. Rating agencies play an important role in the market's analysis of the creditworthiness of issuers and financial instruments. Investors also use rating opinions as a tool in making investment decisions—although it is important for investors to realize that ratings are only one tool, and they should not be used as a substitute for independent investment analysis.

For its part, Standard & Poor's Ratings Services (S&P) is reflecting on what more should be done in the future. It is clear that a number of the assumptions credit rating agencies used between 2005–2007 in rating structured finance bonds backed by subprime mortgages have not held up. One unforeseen development was the extreme nationwide collapse in the U.S. housing market. Rating agencies and others, including banks, insurance companies, regulators, and policymakers, did not anticipate the full extent of what has become a global recession, fuelled by the implosion of the unregulated derivatives market, loose monetary policy, excessive liquidity, and record levels of institutional and personal debt.

Going forward, it is important to the restoration of confidence in the markets that all market participants take stock of what has happened and adopt workable solutions. At S&P, we have been actively applying lessons from the current crisis to adopt a number of constructive measures. We will continue to do so. We also believe regulation can play an important role in this process, and we welcome proposals that would, on a globally consistent basis, increase transparency and preserve the analytical independence of rating agencies' opinions and analytical processes. This White Paper is offered in a spirit of cooperation and openness to promote independent, credible ratings, and to foster investor confidence in the capital markets.

This paper provides S&P's recommendations for what regulations should accomplish generally, as well as specific recommendations that should be instituted globally for credit rating agencies, keeping in mind the necessity of restoring investor confidence and ensuring a fair playing field for investors. This paper also considers the current use of ratings in regulations and investment guidelines.

II. The Goals of Regulation Generally

The current financial crisis has prompted a number of questions about both the regulation of credit rating agencies and the financial regulatory system in general. In large part, the current regulatory structure reflects the fragmented state of the markets from nearly 70 years ago, when banks, securities firms, and insurance companies engaged in distinctly different activities. Today, many of the products and services offered by these financial firms have converged, yet the entities that regulate them and the rules under which they operate remain largely distinct. Regulators find that their jurisdiction does not match the activities of the entities they are regulating. At the same time, new, unregulated players have entered the scene, and products have been developed that fall outside the existing regulatory process. These developments suggest the need for reform of our financial regulatory architecture. Entities that have been

unregulated may require regulation, and some regulatory bodies may require their mandate to be widened to reflect changes in the activities of the entities they regulate. Recent U.S. Government Accountability Office and G-30 group reports call for clearly defined regulatory goals that are global, systemwide, and comprehensive, addressing all roles and processes and taking a flexible approach.

S&P believes any new regulatory architecture should focus on the following goals, both with regard to credit rating agencies and others:

- Safety and soundness of financial markets;
- Business conduct based on transparency and fair dealing;
- Efficiency and cost-effectiveness by aligning responsibilities among different participants across the marketplace;
- Consistency of regulation across similar businesses;
- Internationally consistent standards and coordinated enforcement;
- Adaptability to accommodate future innovations and changes in market structure;
- Flexibility to foster fair competition to benefit investors;
- Promote credit ratings that are analytically sound, independent, and unbiased; and
- Promote competition among rating agencies and differing views on creditworthiness.

III. The General Goals of Regulation of Credit Rating Agencies

S&P believes that well-crafted regulation of credit rating agencies can serve to meet the goals of regulation as described above. It can also serve to enhance the ratings process and restore investor confidence by facilitating consistent application of practical and flexible standards. While regulation should avoid dictating how a rating agency should go about performing its analysis, ultimately, a well-functioning ratings process offers benefits for the economy as a whole by contributing to greater investor confidence.

In order to address areas where investors and policymakers have identified gaps and key issues in the current regulatory regime for credit rating agencies, we have highlighted below the significant investor concerns and expectations we have heard and how regulation might enhance the process.

1. **Independently derived, credible, and unconflicted credit ratings.**

   Appropriate regulation that addresses the effective management of potential conflicts of interest can only benefit the marketplace. This is an area where regulation can be particularly helpful by requiring policies and procedures to address potential conflicts of interest at the institutional and staff levels, including a code of ethics that requires disclosure of potential conflicts, how they are managed, with oversight of the code's effective application for all rating agency business models. Regulations could also prohibit activities that are clearly anticompetitive.

2. **Transparency regarding issuer and rating agency communication.**

   Market participants want to know about the interaction between issuers and analysts during the rating process, particularly where issuers request a structured finance rating.

3. **The meaning and use of ratings should be clear, including the level of risk inherent in the rating.**
   Rating agencies that are transparent about the meaning and limitations of their ratings—for example, clarifying that credit ratings do not address the suitability of a security for any individual investor—are of use to the market. Regulation that requires rating firms to provide publicly detailed explanations about the nature of their opinions and pertinent information used in the rating process would enhance investor knowledge as would regulation that encourages rating agencies to commit to ongoing investor education.

4. **Consistency and comparability of ratings across asset classes and geographies—accountability for ratings quality.**
   Regulation that requires rating agencies to publicly disclose their ratings performance statistics would aid market participants in assessing ratings quality. Rating agencies can be subject to appropriate and proportionate penalties in cases of proven breaches of regulatory requirements.

5. **Transparency and soundness of credit rating analysis.**
   Regulation that requires robust disclosure of the ratings process, including criteria and methodologies for assigning and updating ratings, would give investors critical information they need to make informed decisions, to compare ratings, and to form their own opinions on the soundness of an agency's analytics. A similar result could be achieved through regulation that requires identification of the models and underlying assumptions used in a rating agency's analysis. There is a particular need to identify such models and assumptions in structured finance. In addition, regulation that requires agencies to publicize their ratings performance statistics and allows for comparison across geographies, certain asset classes, and with competitors would inform independent investor analysis. Rating agencies could add to this informational process by making personnel available to explain their methodologies to users.

6. **Clear and consistent applications of policies to lessen "surprises" when and if ratings are changed.**
   Rating agencies that use "warning signals" whenever possible, such as S&P's CreditWatch and Outlook signifiers—to signal to the marketplace potential future rating changes—are important to investors. However, rating users need to understand that ratings can change suddenly based on market or industry-specific events. This possibility is a reason that regulators might carefully reconsider using ratings exclusively in their regulations.

7. **Ratings on new and different securities should be differentiated.**
   The current financial crisis has highlighted the need for markets to better understand the meaning of ratings on new and complex securities, including structured finance ratings, and how they differ from traditional ratings. Regulation could play a role in making those differences transparent.

8. **Availability of information, particularly for structured finance ratings.**
   Rating agencies that utilize the issuer-pay model receive confidential information from issuers and others throughout the rating and surveillance process. Regulation that requires agencies to follow policies and procedures to avoid the disclosure and misuse of confidential information would be consistent with the spirit of current securities regulation. Where markets and regulators believe the confidential information should be made available to a rating agency's competitors or to others, regulation should require issuers and others responsible for the quality of that data to make this information widely available.

9. **Confirm that rating agencies are following through on their commitments.**
   Regulation that provides for regulatory authorities to check agencies' compliance with their processes and policies through robust, periodic inspections would be beneficial to promoting ratings quality. However, regulators must protect analytical independence by avoiding rules and examination processes that impact the substance of rating opinions and an agency's analytics.

10. **Competitive market for ratings with more and varying views on credit quality from qualified providers.**
    Ratings based on a high degree of integrity and intellectual rigor benefit the marketplace, and formal registration of credit rating agencies and promotion of increased industry competition should help in this area. A registration regime that follows globally consistent standards can serve as a model. Regulators that are transparent about the criteria they use in accepting applications, including the need for sufficient analytical and financial resources, would act as a uniting force in establishing a global regulatory framework. Regulation that requires disclosure about staffing, number of ratings issued, and training requirements would allow regulators to make more informed decisions regarding the adequacy of an agency's resources. Regulators could also increase their ability to evaluate agencies by analyzing financial information from agencies provided to regulators on a confidential basis. Regulators should be careful, however, not to attempt to supplant their own judgments about ratings analysis for that of independent rating agencies. Evaluations as to the quality of ratings and ratings processes should be left ultimately to the market.

IV. Specific Recommendations for an International Regulatory Framework for Credit Rating Agencies

Credit rating agencies conduct business in numerous countries across the globe. A regulatory framework that provides consistent standards across jurisdictions can promote the soundness of international, as well as domestic, business.

One potential model for an international regulatory approach is the IOSCO Code of Conduct, recently updated in May 2008. For example, in the U.S., credit rating agencies are subject to the Credit Rating Agency Reform Act of 2006, which sets standards that to a significant degree mirror those established under the IOSCO Code of Conduct.

Regulators in Europe, Japan, and Australia are actively reviewing formal oversight of rating agencies. Regulators in any country should take care before seeking to exceed existing standards given the effect such an approach could have on rating agencies operating in multiple jurisdictions. These agencies may face conflicting rules that could ultimately harm ratings consistency due to country- or region-specific requirements.

A sound regulatory framework for rating agencies globally should have the following components:

Registration. One feature of a globally workable regulatory regime would be to have rating agencies register in the jurisdiction of their principal place of business and only allow registration of those that

have in place standards to promote ratings integrity. From its home jurisdiction, a rating agency could be recognized to do business in other jurisdictions pursuant to a notice filing with the local regulator. This "passport" would allow for a streamlined and consistent regulatory approach across all the jurisdictions in which the credit rating agency conducts business. Regulators could consider limiting regulation to agencies whose ratings are used in local laws or regulations.

Performance Measurement. Another feature would be to require registered rating agencies to publicly issue performance measurement statistics over the short, medium, and long term, and across asset classes and geographies.

Disclosure of Rating Methodologies. Registered credit rating agencies could also be required to make robust disclosures regarding the analytical bases of their ratings opinions, the type of information used to arrive at ratings, and their internal standards for promoting consistency and for monitoring and updating ratings. With greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions.

Control over Non-public Information and Disclosure of Underlying Data. By having access to non-public information, rating agencies are in a position to provide more informed analysis, thus potentially enhancing the quality of the ratings they provide. Accordingly, any regulatory regime for credit rating agencies should ensure that agencies have policies and procedures requiring their employees to treat non-public information confidentially. Regulators should understand that, if such information is disclosed to a rating agency, including to rate a structured finance product, the responsibility for the quality of the information provided and the disclosure to the marketplace in a broad and fair manner rests with the issuer and the underwriter. Regulators should consider if compulsory disclosure by issuers and underwriters of confidential information would be more efficient and beneficial to the marketplace. Such rules would allow competing agencies and sophisticated market participants to evaluate in greater detail the analysis and assumptions of the rating agency.

Organizational Transparency. Registered credit rating agencies should be required to disclose detailed information about their organization's structure, including their resources, their independence from any particular issuer, their ability to train and retain employees, and the independence of commercial from analytical functions. Rating agencies should provide pertinent information about their financial resources to regulators on a confidential basis. This disclosure will allow regulators to assess the viability of agencies.

Development of Code of Ethics. Rating agencies should develop and disclose to the public a detailed code of ethics, including a description of how that code will be enforced and how it relates to broader principles such as existing industry or regulatory standards. An independent officer or ombudsman should be established to communicate with the public regarding concerns that might arise about the code's enforcement.

Elimination of Potential Conflicts of Interest. A regulatory regime must include robust standards for analyst and employee independence and the procedures for mitigating potential conflicts of interest in the ratings

process. Regulation should require disclosure of such conflicts and prohibit analysts from performing commercial activities and providing consulting or advisory services to entities they rate. In this regard, regulation should require disclosure of the guidelines for analyst and issuer interaction. Regulation should prohibit analysts from being compensated based on the fees paid by the entities they directly rate.

Prohibitions on Anti-Competitive Activity. A regulatory regime should prohibit unfair, abusive, or coercive activity. Certain activities should be prohibited outright, such as threatening an issuer with an unfavorable rating or threatening to withdraw an existing rating unless the rating agency is paid to rate an issue.

Transparency of Models. A regulatory regime should require policies and procedures on the use and transparency of models, assumptions, and how agencies check their effectiveness, including through the use of third parties.

Accessibility. A regulatory regime should require a mechanism for ratings users to raise questions about methodologies and should require registered credit rating agencies to have in place personnel to answer these questions.

Effective Oversight. A regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and without second-guessing rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard in influencing a rating outcome.

Analytical Independence. Regulators must preserve the analytical independence of rating agencies' opinions, analytical processes, and methodologies. This independence is critical to restoring confidence in credit ratings and fostering innovation in financial services.

Accountability. A regulatory regime should hold registered rating agencies accountable for established breaches of the regulations without undermining analytical independence. Sanctions may include penalties proportionate to the nature and seriousness of any breach, suspending or removing an agency's registration, and disallowing the continued use of that agency's ratings for regulatory purposes.

International Consistency. Regulatory regimes globally must be consistent in applying standards. Regulators should coordinate in exercising oversight of rating agencies subject to regulation beyond their own borders. This will avoid inconsistent rules and inconsistent handling of infractions that would create uncertainty for analysts and users of ratings. Regulators should commit to sharing information subject to confidentiality undertakings.

Meaning of Ratings. Rating agencies should clearly explain the meaning of their credit ratings and what elements they do not address: for example, suitability of investments for any particular investor.

Differentiate New and Complex Ratings. A regulatory regime could require that new and complex ratings, including structured finance products, be differentiated in some manner to put investors on notice that potential volatility or the types of underlying assets/data for rating structured products may be distinguishable from factors affecting corporate and municipal ratings.

V. Use of Ratings in Regulations

The use of ratings in regulations and investment guidelines has been debated in global markets. We believe that if regulators and policymakers choose to incorporate ratings in their rules as benchmarks to measure creditworthiness, then the use of additional benchmarks may also be warranted. There may be additional appropriate benchmarks for market participants to choose from—whether in regulations, investment guidelines, or private agreements—that would protect against "credit cliffs," namely situations when rating downgrades can occur quickly and without forewarning. Where regulations mandate minimum rating levels, credit cliffs can cause market disruption and significantly impair the liquidity of downgraded securities.

VI. Regulation of Other Market Participants

Ratings play only one role, among many, in the investment decision-making process. Others, such as auditors, play a unique role that rating agencies should not be expected to play because that would add unnecessary costs and inefficiencies to the system. Regulation should address the role of various market participants such as mortgage lenders and originators in addition to the role of rating agencies.

VII. Conclusion

This is a broad outline of a general approach to regulation of credit rating agencies and some specific suggestions for an international regulatory approach for credit rating agencies. It provides a framework for addressing the regulatory challenges of a global, fast-paced, rapidly changing market in which new financial instruments, products, markets, and participants are constantly emerging, the status quo is constantly changing, and market participants have little time to assess the impact of any change. An agreement in principle on this type of framework would open the path for further work aimed at developing more specific provisions.

But no aspect of the marketplace can be reviewed or regulated in isolation. Regulators and lawmakers should also review their regulatory regimes for all market participants. The current global financial crisis calls for a full and transparent review. No doubt the structure put in place in the coming months will set the foundation for oversight of a broad array of financial market participants for years to come. S&P looks forward to assisting regulators and policymakers in crafting fair, effective, and transparent regulation that will serve our global markets going forward.

For more information about Standard & Poor's actions to strengthen the ratings process, go to www.spnewactions.com.

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