CREDIT RATING AGENCIES: DEVELOPMENTS AND POLICY ISSUES

Credit rating agencies play a vital role in global securities and banking markets. It is thus essential that they consistently provide ratings that are independent, objective and of the highest possible quality. Following the criticism voiced with regard to their role in creating the conditions for the processes that led to the unfolding of the financial crisis, the assessments made by various international and national bodies have triggered a policy debate about the need to strengthen the regulatory framework for credit rating agencies. This article reviews the main aspects of the policy debate and describes the most important developments relating to the regulatory treatment of credit rating agencies.

1 INTRODUCTION

The credit ratings produced by rating agencies are aimed at measuring the relative credit quality of companies and debt instruments. Such credit quality is understood to mean the ability to meet debt servicing obligations. The basic rationale behind using ratings is to achieve economies of scale in terms of the collection and analysis of information and to solve problems deriving from asymmetric information between issuers and investors (i.e. principal-agent problems).[1] The role and influence of credit rating agencies has expanded significantly over time. A large number of market participants have embedded credit ratings in their investment and credit assessment frameworks. At the same time, regulators have increasingly used rating-linked regulation. As the markets evolved and became more complex, credit rating agencies were expected to cover a wider range of markets and debt instruments. In this environment of growing financial innovation and expanding credit markets, the rating agencies were under considerable pressure to provide an ever increasing number of credit assessments without any loss of quality. In addition, most market participants, even the supposedly most sophisticated ones, did not undertake due diligence work, but rather outsourced their credit risk management to rating agencies and relied on them. In the aftermath of the sub-prime crisis in the United States, credit rating agencies were widely blamed for initial ratings of structured finance securities that did not reflect the true risks inherent in those securities. Indeed, rating agencies' models did not foresee the high level of delinquencies that materialised in US mortgage-backed securities, nor the inadequate design of liquidity support mechanisms for securitised transactions that, given their dependence on the rollover of debt issued by structured investment vehicles (SIVs), failed when conditions in the money markets worsened markedly. In addition, critics pointed to the poor surveillance of the deteriorating dynamics of the collateral pools backing mortgage-backed securities that had already been visible before the major dislocations occurred in the asset-backed securities markets in mid-2007. Commentators also highlighted conflicts of interest that were perceived to exist on account of the business models followed by rating agencies in which they provide issuers and financial intermediaries with advice at the stage when a transaction is structured, as well as the rating agencies' practice of being paid directly by the issuers or originators of securitised transactions.

Against this background, international and national authorities undertook a number of initiatives. At the international level, in May 2008 the International Organization of Securities Commissions (IOSCO) reviewed its Code of Conduct for credit rating agencies so as to strengthen its guidelines on the quality and integrity of ratings, as well as on credit rating agencies' independence and the avoidance of conflicts of interest. In the United States, the Securities and Exchange Commission (SEC) strengthened the regulatory framework with a view to better addressing issues such as managing concerns about conflicts of interest, improving transparency and making sure that the regulatory framework does not rely

1 F. González, F. Haas, R. Johannes, N. Persson, L. Toledo, R. Violi, M. Wieland and C. Zins, "Market dynamics associated with credit ratings, a literature review", *Occasional Paper Series,* No 16, ECB, Frankfurt am Main, June 2004.

excessively on ratings. In Europe, the European Commission, after a public consultation, adopted a legislative proposal for a regulation on 12 November 2008.

This article is aimed at providing an overview of the main policy initiatives under way and is structured as follows: Section 2 describes the regulatory developments that took place before the start of the financial crisis; Section 3 refers to the policy debate that was triggered by the financial crisis; Section 4 summarises the initiatives taken by the Eurosystem for the oversight of the credit rating agencies; and Section 5 concludes.

2 OVERVIEW OF THE REGULATORY DEVELOPMENTS CONCERNING CREDIT RATING AGENCIES BEFORE THE 2007 FINANCIAL CRISIS

The credit rating market has a specific structure as it is dominated by three large international firms (Standard & Poor's, Moody Investors Service and Fitch Ratings). These entities have their head offices and main management in the United States and operate within the EU through subsidiaries established in several countries.[2] These features of the rating industry underline the international nature of the policy debate on possible regulatory initiatives concerning credit rating agencies, given the importance of close cooperation at the international level and the need for consistency in the standards applied to global firms.

The policy debate on the need for enhanced regulatory measures concerning credit rating agencies started in 2003, in the aftermath of major corporate scandals in the EU and the United States. As rating agencies were blamed for not having anticipated such corporate failures, a number of policy initiatives were triggered.

At the international level, IOSCO issued a report and a Statement of Principles for regulators, credit rating agencies and other market participants in September 2003 to improve their safeguards for the integrity of the rating process.[3] It was followed in December 2004 by the publication of a Code of Conduct[4] that was to serve as a model upon which credit rating agencies could base their own codes of conduct for the implementation of the IOSCO Principles.

In Europe, following a Resolution passed by the European Parliament in February 2004,[5] the European Commission, having sought the advice of Committee of European Securities Regulators (CESR), adopted a Communication on 11 March 2006, in which it concluded that no new legislative initiative was needed.

More specifically, the Commission concluded that the existing financial services directives applicable to credit rating agencies,[6] combined with self-regulation on the basis of IOSCO's Code of Conduct Fundamentals for Credit

2 For an overview of the structure of the large credit rating agencies and a list of credit rating agencies, see *Impact assessment accompanying the European Commission's proposal for a regulation of the European Parliament and of the Council on credit rating agencies*, 12 November 2008.

3 *IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*, September 2003, available at www.iosco.org.

4 IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies*, December 2004, available at www.iosco.org. The Code comprises three main parts, namely: Quality and Integrity of the Rating Process; Independence and the Avoidance of Conflicts of Interest; and Responsibilities to the Investing Public and Issuers.

5 European Parliament resolution on the role and methods of rating agencies (2003/2081(INI)), available at www.europarl.europa.eu.

6 In particular, the Market Abuse Directive (MAD); the Capital Requirements Directive (CRD) and the Markets in Financial Instruments Directive (MiFID). The Commission highlighted the following:
The MAD deals with insider trading and market manipulation (market abuse). It addresses the fair presentation of investment recommendations and the disclosure of conflicts of interest. For the purposes of the MAD, credit ratings do not constitute a recommendation, but are regarded as opinions on the creditworthiness of a particular issuer or financial instrument. However, it is stipulated that CRAs should consider adopting internal policies and procedures designed to ensure that the credit ratings they publish are fairly presented.
The CRD provides for the use of external credit assessments in the determination of the risk weights (and resulting capital requirements) applied to a bank or investment firm's exposures. The CRD sets out a number of requirements that external credit assessment institutions (ECAIs) should meet before the competent authority grants them recognition.
The MiFID provisions regarding business conduct and organisational requirements are applicable to credit rating agencies that also provide investment services on a professional basis.

Rating Agencies by the credit rating agencies themselves, would provide an adequate answer to all the major issues of concern. In addition, the Commission asked the CESR to monitor the credit rating agencies' compliance with the IOSCO Code and to report annually thereon.[7]

In the United States, the existing regulatory framework on Nationally Recognized Statistical Rating Organizations (NRSROs) was amended with the adoption of the Rating Agency Reform Act in 2006.

The Rating Agency Reform Act provided for the registration of NRSROs with the SEC, which was given the authority to implement financial reporting and oversight rules for registered NRSROs. The Rating Agency Reform Act also authorised the SEC to impose reporting and record-keeping requirements, as well as to examine the rating activities of NRSROs. Nonetheless, the Rating Agency Reform Act expressly prohibited the SEC from regulating "the substance of the credit ratings or the procedures and methodologies" by which any NRSRO determines credit ratings.

The implementing rules of the SEC became effective on 26 June 2007. Under the new framework, NRSROs were required to make public disclosures related to their activity, to retain certain records, to furnish certain financial reports to the SEC, to establish procedures for the management of material non-public information and to disclose and manage conflicts of interest. In addition, the SEC's rules prohibit an NRSRO from having certain conflicts of interest and engaging in certain unfair, abusive or coercive practices.

3 THE POLICY DEBATE CONCERNING CREDIT RATING AGENCIES AFTER THE START OF THE FINANCIAL CRISIS

3.1 WEAKNESSES REVEALED BY THE FINANCIAL CRISIS

In the first quarter of 2007 some investors started to question the accuracy of the ratings given to certain structured finance instruments and, in particular, to residential mortgage-backed securities (RMBSs) and collateralised debt obligations (CDOs). Indeed, it has been argued that these questions about the quality of the agencies' ratings and the integrity of the rating process added to the liquidity crisis that occurred on financial markets as from August 2007.[8]

Various analyses of the financial crisis have highlighted concerns about both the weakness of the methodologies used by credit rating agencies in rating structured finance instruments and the lack of incentives for conducting an independent assessment since they are paid by the issuers.

The Report of the Financial Stability Forum (FSF), for instance, which was published on 7 April 2008, summarised the main sources of concern about the credit rating agencies' performance as follows: "weaknesses in rating models and methodologies; inadequate due diligence in monitoring the quality of the collateral pools underlying rated securities; insufficient transparency about the assumptions, criteria and methodologies used in rating structured products; insufficient information provision about the meaning and risk characteristics of structured finance ratings; and insufficient attention to conflicts of interest in the rating process."[9] The FSF also presented a number of recommendations for further action. These related to the quality of the rating process; differentiated rating and expanded information on structured products; the credit rating agencies' assessments of underlying data quality; and the use of ratings by investors and regulators. Other analyses conducted by international organisations and public authorities

7 In December 2006 the CESR published its first annual report. It concluded that the main credit rating agencies subscribing to the CESR's voluntary monitoring scheme were generally compliant with the IOSCO Code.

8 See IOSCO, *Final Report on the subprime crisis*, May 2008, pages 2 ff.

9 Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,* 7 April 2008, page 8.

in the United States and in Europe concurred with the identification of the above-mentioned concerns.[10]

The Eurosystem has a keen interest in the policy debate on possible regulatory measures concerning credit rating agencies for the following reasons.

First, credit rating agencies play an important role in the functioning of markets by reducing information asymmetries between issuers and investors, thus contributing to a more efficient allocation of risks and resources by market participants.

Second, events during the market turmoil have shown that the perception of shortcomings in the rating activity performed by credit rating agencies may erode market confidence and might adversely affect financial stability.

Third, the Eurosystem is directly impacted by the services that rating agencies provide in the context of Eurosystem tasks and obligations with regard to both the conduct of monetary policy operations and asset management operations. Article 18(1), second indent, of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute) stipulates, in particular, that the ECB and the national central banks may "conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral". In this respect, one important criterion that assets must fulfil in order to be eligible for use as collateral in monetary policy operations is that they must meet high credit standards. In the assessment of the credit standards of eligible assets, the Eurosystem takes into account, inter alia, credit assessments deriving from different sources, including credit rating agencies that are defined as "external credit assessment institutions" (ECAIs). The latter are subject to general acceptance criteria, complemented by a multi-annual performance monitoring process in accordance with the conditions published in the ECB's Guidelines on monetary policy instruments and procedures of the Eurosystem.

Against this background, the Eurosystem's view is that initiatives concerning credit rating agencies should be aimed at attaining the following three main objectives:[11]

- *Increase transparency about the issuance of ratings and the ongoing surveillance of those ratings*: improved disclosure standards would allow a better comparison of credit rating agencies' rating assessments, thereby increasing competition and innovation in the sector by creating opportunities for peer review and by eliminating possible competitive disadvantages that result from the lack of access to underlying collateral information.

- *Ensure that the rating process meets adequate standards of quality and integrity*: the models and processes used for issuing ratings should be based on sound assumptions that avoid an excessive volatility of ratings, which could result in a sharp repricing of assets and impair market confidence. The regulatory framework should also facilitate the conduct of stress tests by users on key model parameters, and provide for the disclosure by credit rating agencies of the economic assumptions underlying their rating of structured products.

- *Safeguard the integrity and independence of credit rating agencies*: conflicts of interest should be either avoided or properly addressed within a transparent regulatory framework, which would need to be properly enforced.

10 See IOSCO, *Final Report on the subprime crisis,* May 2008; SEC, *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies,* July 2008; European Commission, *Impact assessment accompanying the proposal for a regulation of the European Parliament and of the Council on credit rating agencies*, 12 November 2008.

11 For more details, see the Eurosystem's reply to the European Commission's public consultation, as published on the ECB's website on 25 September 2008.

In addition, the conflict of interests caused by the rating industry's business model of payment by the issuer could be addressed in greater depth in the medium term.

Recognition of the aforementioned issues led to a number of initiatives on the part of both the industry and public authorities, as set out in further detail below.

3.2 MARKET INITIATIVES AIMED AT SELF-REGULATION

Credit rating agencies have recently announced changes to enhance the integrity of their rating processes. Some of these changes have already been implemented and some are on the verge of implementation, subject in some cases to awaited market feedback. Credit rating agencies are very much aware of the fact that the failures recorded in structured finance ratings have dented the confidence of market participants and regulators in the agencies' ability to assess credit quality. These changes reflect the urgent need to take any possible action that can contribute to the restoration of credit rating agencies' unique role as "gate keepers" of the global credit markets.

In the joint report they submitted to IOSCO in April 2008, five credit rating agencies undertook to implement on a timely basis a number of measures to enhance the independence, transparency and quality of the credit rating process and to help restore confidence in the credit rating industry.[12] While many of the proposed measures are quite essential in character, they try to overcome some of the fundamental failures that were overlooked in "normal" times, i.e. when financial markets are not under stress. It is recognised that those basic elements did not receive the required priority, in particular at a time of rapid growth and market excess.

An underlying theme in the self-promoted changes is the understanding by rating agencies that the resolution of the current crisis of confidence in the rating industry rests primarily with the agencies themselves and that regulatory intervention in isolation is not the solution to overcome this crisis of confidence. Public regulation may be counterproductive as it might be seen by market participants as implying an official endorsement of ratings issued by rating agencies, which may not be desired for the proper functioning of credit markets.

While the three areas of action listed by the credit rating agencies in their self-regulatory action plans coincide with the three objectives of the ECB as regards possible regulatory intervention with respect to credit rating agencies (independence, quality of ratings and transparency), it is questionable as to whether the self-proposed measures are far-reaching enough in tackling the areas of concern. In total, there are 22 concrete measures that the five credit rating agencies have committed to put in place, six of which relate to the independence of the credit rating process, while eight concern the quality of credit ratings and eight transparency. As discussed earlier, these measures are quite important when viewed individually, but do not go deep enough to fully address the concerns raised during the financial crisis as regards the functioning and role of the credit rating agencies in developed credit markets.

3.3 US INITIATIVES

On 11 June 2008 the SEC proposed new rules concerning credit rating agencies to supplement those implemented under the Credit Rating Agency Reform Act in June 2007, aimed at increasing the transparency of the ratings process and at curbing practices that had contributed to recent turmoil in the credit markets.[13]

In particular, the SEC proposed:

(i) to prohibit credit rating agencies both from issuing a rating on a structured products

12 Joint response of A.M. Best Company, Inc., DBRS Limited, Fitch, Inc., Moody's Investors Service, Inc., and Standard & Poor's Rating Services to the *IOSCO Technical Committee Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets*, April 2008.

13 See www.sec.gov/news/press/2008/2008-110.htm.

unless information is available on the assets underlying the product and from structuring any products that they rate themselves;

(ii) to require credit rating agencies to differentiate ratings they issue on structured products from those they issue on bonds, either through the use of different symbols or by issuing a report disclosing the differences between ratings of structured products and those of other securities; and

(iii) to remove references to NRSRO ratings from the rules and forms set out in the Securities Exchange Act of 1934 so as to ensure that the role the SEC has assigned to ratings in its rules is consistent with the objective of having investors make an independent judgement of risks and of making the limits and purposes of credit ratings for structured products clear to investors. Such intervention addressed concerns that the use of NRSRO ratings in SEC rules and forms may have contributed to an undue reliance on NRSRO ratings.[14]

Finally, on 3 December 2008, the SEC approved a series of measures to increase transparency and accountability at credit rating agencies, and to ensure that firms provide more meaningful ratings and greater disclosure to investors.[15] The SEC's actions were based on its extensive ten-month examination of three major credit rating agencies, which had found significant weaknesses in ratings practices.

3.4 EU INITIATIVES

In the EU, at the request of the European Commission, the CESR prepared a report in May 2008 on the process of rating structured finance instruments in the context of the recent turmoil, in which it highlighted specific actions to improve the conduct of credit rating agencies. On 31 July 2008 the European Commission published two consultation papers concerning (a) a complete regulatory framework for credit rating agencies and (b) policy options to address the problem of an excessive reliance on ratings.

Following the consultation and the request by the EU Council of 16 October 2008 for a proposal to strengthen the rules on credit rating agencies and their supervision at the EU level, the European Commission adopted an appropriate legislative proposal on 12 November 2008.

The proposal lays down conditions for the issuance of credit ratings that are needed to restore market confidence and increase investor protection. More precisely, the proposal is intended to enable European supervisors to control the activities of agencies whose ratings are used mainly for regulatory purposes by credit institutions, investment firms, insurance and reinsurance undertakings, collective investment schemes and pension funds within the EU.

In November 2008 the Commission presented its formal proposal for a regulation, and in March 2009, the final text was submitted to the Ecofin Council and, subsequently, to the European Parliament for adoption.

14 See www.sec.gov/news/speech/2008/spch062508ers-2.htm.
15 See www.sec.gov/news/press/2008/2008-284.htm.

Box

THE EUROPEAN COMMISSION'S PROPOSAL

The main elements of the European Commission's proposal are as follows.

Independence and avoidance of conflicts of interest

The proposal seeks to reform internal governance structures, introducing sound internal controls and reporting lines, and clearly separating the rating function from business incentives. External surveillance is strengthened by giving specific tasks to the independent members of the administrative or supervisory board of the credit rating agencies. Credit rating agencies are also requested to limit their activity to credit ratings and related operations, excluding consultancy or advisory services. The employees are subject to rotation mechanisms.

Quality of ratings

The new requirements are intended to allow sophisticated market participants to check the soundness of methodologies used and to verify the rating issued by the credit rating agency, but also to increase market discipline. In order to meet these goals, credit rating agencies are required to disclose in a timely manner the methodologies, models and key assumptions they use for rating. Methods must be kept up to date and subject to review, and credit rating agencies must constantly review their ratings. In addition, credit rating agencies are required to use methodologies that are rigorous, systematic and subject to validation based on historical experience.

Enhanced transparency

Credit rating agencies must disclose information about conflicts of interest, methodologies, key rating assumptions and the nature of their compensation policy. They must also regularly disclose data on the historical default rates of rating categories, with the CESR creating a publicly available central repository for such data. Credit rating agencies must publish an annual transparency report and keep records of their activities.

Registration and supervision of credit rating agencies

The proposal establishes the CESR as the "single entry point" for registration, since it is best placed to provide a "one-stop shop" for applications and a central point for informing and coordinating all national regulators in the EU. However, the responsibility for the registration of credit rating agencies rests with the competent authority of the home Member State. To function as a single entry point, the CESR should be closely involved in the registration process from the outset and be entitled to advise on the granting or withdrawal of the registration by the competent authority of the home Member State, and may request a re-examination of draft decisions.

The supervision of a credit rating agency is carried out by the competent authority of the home Member State, in cooperation with the competent authorities of the other Member States concerned. The competent authorities are asked to establish and operate through a college of supervisors, and to keep the CESR appropriately informed. Indeed, the CESR is asked to provide advice on and, in cooperation with the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), issue guidance on various issues, including coordination arrangements between competent authorities; enforcement practices and activities; and common standards on the information to be disclosed by credit rating agencies.

In order to enable the competent authorities to carry out their duties in conformity with national law, the proposal gives them the following powers:

- to be granted access to any document in any form and to receive or take a copy thereof;
- to demand information from any person and, if necessary, to summon and question a person with a view to obtaining information;
- to carry out on-site inspections; and
- to require records of telephone and data traffic.

The competent authorities can exercise their powers directly, in collaboration with other authorities, or by application to the competent judicial authorities. Where the competent authority establishes that a registered credit rating agency is in breach of the obligations arising from the regulation, it may impose sanctions, including the withdrawal of the registration, a temporary prohibition of issuing credit ratings and/or the suspension of the use of credit ratings for regulatory purposes. For sake of clarity, among the obligations whose violation may trigger the adoption of sanctions by the competent authorities, the proposal frequently makes reference to requirements concerning independence and avoidance of conflicts of interests.

The proposal requires competent authorities to cooperate. In this respect, it stipulates that, in cases of conflict, competent authorities shall refer the matter to the CESR for mediation. Moreover, the competent authorities must, without undue delay, supply one another with the information required for the purposes of carrying out their duties under this regulation. The competent authorities may provide supervisory authorities, central banks, the ESCB and the ECB, and to any other public authorities responsible for overseeing payment and settlement systems with confidential information intended for the performance of their tasks.

It is worth noting that some of the proposed rules are based on the standards set out in the IOSCO Code. The proposal gives those rules a legally binding character. Moreover, in those cases where the IOSCO standards are not sufficient to restore market confidence and ensure investor protection, the European Commission has proposed stricter rules.

At the time of writing, the EU Council and the European Parliament are discussing the European Commission's proposal. The political negotiation may lead to important changes in the proposed regulatory framework.

3.5 THE ECB'S VIEWS ON THE EUROPEAN COMMISSION'S PROPOSAL

One of the issues subject to intense debate in the European context concerns the main element of a framework at the EU level that would provide for an adequate coordination of national authorities' activities in the field of the registration and oversight of credit rating agencies.

In its response to the public consultation launched by the European Commission on 31 July 2008, the Eurosystem expressed its support of a coordinative role for the CESR within a framework that provides for the close involvement of all relevant national authorities. The Eurosystem also highlighted that any coordination arrangement established for the regulation and supervision of credit rating agencies should be designed with due consideration of two elements, namely (i) the need to avoid any duplication of procedures with those put in place by banking supervisors to recognise credit rating agencies as ECAIs in accordance with the requirements laid down by the Capital Requirements Directive (CRD) and (ii) the need to provide for an appropriate level of involvement by the Eurosystem, given both its keen interest from a financial stability perspective and the fact that it has already established a Eurosystem-wide framework to monitor credit rating agencies' functioning and performance.

As regards the envisaged supervisory framework for credit rating agencies, which is centred on securities regulators with a coordinative role played by the CESR, appropriate arrangements should be in place to ensure coordination with both banking supervisors and central banks.

First, with regard to the cooperation with banking supervisors, the Eurosystem welcomes the introduction of provisions aimed at ensuring that the proposed regulation encompasses all the criteria that must be fulfilled under the ECAI recognition process. This would prevent credit rating agencies from being subject to requirements that overlap or conflict with those set for authorisation under the proposed regulation. Moreover, the Eurosystem welcomes the introduction of the mandatory consultation of the CEBS (as well as the CEIOPS) prior to the publication of guidance for competent national authorities.

Second, as regards the coordination arrangements with the ECB and the Eurosystem, the proposed regulation should be in line with changes recently proposed on the CRD[16] for the exchange of information between securities regulators, central banks and the ECB. In particular, the regulation should allow the transmission of information from the competent national authorities to the EU central banks, including the ECB, if such information is of relevance for the performance of key central bank tasks, such as the conduct of monetary policy, the oversight of payments and securities settlement systems, and the safeguarding of financial stability.

At the time of writing, the ECB is finalising the preparation of its opinion on the European Commission's proposal.

4 THE OVERSIGHT OF CREDIT RATING AGENCIES BY THE EUROSYSTEM AS PRESCRIBED BY THE EUROSYSTEM CREDIT ASSESSMENT FRAMEWORK

In its capacity as a monetary authority, the ECB currently monitors the performance and activities of rating agencies. In the context of the implementation of monetary policy operations, it does so through the so-called Eurosystem Credit Assessment Framework (ECAF) for eligible collateral. The ECAF is the set of rules and regulations that ensure that collateral used by counterparties to back the credit obtained in monetary policy operations is of adequate quality. One important task of the ECAF is to ensure that credit rating agencies eligible for ECAF purposes, used as a source of information for the credit assessment of collateral, conform to certain performance and operational standards that are defined by the Eurosystem.

The performance monitoring framework defined by the ECB is applied consistently across the different eligible rating agencies and consists of an ex post assessment of the ratings issued by the rating agency by way of a back-testing procedure. To this end, the ECB requires all eligible rating agencies to provide static pools with information on obligors rated at a given rating class at the beginning of the year and whether they have transitioned to another rating

16 See the recent Commission proposal amending the CRD (Directives 2006/48/EC and 2006/49/EC).

class or defaulted. The results of such analysis are shared with the rating agencies, and any possible deviation from the expected performance is discussed and possible follow-up measures to improve performance are agreed with the rating agency. The current framework allows a rating agency to be excluded in severe circumstances of underperformance over a pre-specified period of time if it does not improve its rating output.

The ECAF also ensures that the mapping of the different rating scales of the various rating agencies is correctly implemented. This requires a good understanding of the meaning of the rating output of rating agencies. Therefore background information that permits a correct construction of rating mapping tables is required from rating agencies on a regular basis.

In addition, the ECB enters into a direct dialogue with the ECAF credit rating agencies in areas such as a better disclosure of rating analysis, surveillance performance information and improvements to rating methodologies. A special focus is put on better transparency of the surveillance processes conducted by rating agencies in the area of structured finance. Since the start of the financial crisis, the ECB has modified its risk control framework to improve the transparency of ratings of asset-backed securities.[17] Asset-backed security ratings must be explained in a publicly available credit-rating report (either a detailed pre-sale report or a new issue report). This report must include a comprehensive analysis of the structural and legal aspects, a detailed analysis of the collateral pool, an analysis of the transaction participants and any other relevant particularities of the transaction. Moreover, rating agencies must publish rating reviews at least on a quarterly basis.[18] These reports should at least contain an update of the key transaction data (e.g. the composition of the collateral pool, transaction participants and the capital structure) as well as performance data. The ECB is currently working with rating agencies on the enhancement of the surveillance performed by rating agencies with a view to introducing loan-by-loan level information in the ongoing surveillance process for asset-backed securities that are eligible for Eurosystem operations. Failures in the surveillance processes of ratings of US sub-prime asset-backed securities are believed to have played an important role in the start of the financial crisis. These efforts will improve the quality of the surveillance process by allowing rating agencies to identify early any possible problems with the underlying assets backing the transactions. It is hoped that by improving transparency in the surveillance process, market participants can regain confidence in the work performed by rating agencies in the securitisation markets, thereby allowing their reactivation.

5 CONCLUSIONS

The global nature of the credit rating industry requires agreement at the international level about the main elements of the regulatory response to the shortcomings revealed by the financial crisis. Therefore, the Eurosystem welcomes the agreement reached by the G20 leaders on 2 April 2009 with regard to the introduction of an oversight regime for credit rating agencies whose ratings are used for regulatory purposes, which will include mandatory registration, as well as rules and procedures for managing conflicts of interest and for ensuring the transparency and quality of the rating process. The oversight framework should be consistent across jurisdictions, with an appropriate sharing of information between national authorities, also through IOSCO.

Moreover, national authorities should be given the authority to enforce compliance and require changes to a credit rating agency's practices and procedures for managing conflicts of interest and assuring the transparency and quality of the rating process. Finally, given the global scope of some credit rating agencies, the oversight framework should be consistent across jurisdictions, with an appropriate sharing of information between

17 See the ECB's press release of 4 September 2008 on the biennial review of risk control.

18 For asset-backed securities whose underlying assets pay principal or interest at a semi-annual or annual frequency, surveillance reports can follow a semi-annual or annual frequency respectively.

the national authorities responsible for the oversight of credit rating agencies. In particular, the role of IOSCO to continue to ensure the consistency of regulations concerning credit rating agencies across jurisdictions, through regular reviews and updates of the Code, would be of pivotal importance to ensure that market participants can continue to have confidence in the reliability of the ratings provided by credit rating agencies.