

**REPORT ON THE ACTIVITIES OF  
CREDIT RATING AGENCIES**



**OICJ-IOSCO**

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## I. INTRODUCTION

Credit rating agencies (CRAs) can play an important role in many domestic and cross-border transactions. CRAs assess the credit risk of corporate or government borrowers and issuers of fixed-income securities. CRAs attempt to make sense of the vast amount of information available regarding an issuer or borrower, its market and its economic circumstances in order to give investors and lenders a better understanding of the risks they face when lending to a particular borrower or when purchasing an issuer's fixed-income securities.<sup>1</sup> A credit rating, typically, is a CRA's opinion of how likely an issuer is to repay, in a timely fashion, a particular debt or financial obligation, or its debts generally.

Issuers, lenders, fixed-income investors, and government regulators use credit risk assessments for a variety of purposes. Issuers and corporate borrowers rely on (and, in many cases, pay for) opinions issued by CRAs to help them raise capital. Investors and lenders typically insist on being compensated for uncertainty and, when taking on debt, issuers pay for this uncertainty through higher interest rates.<sup>2</sup> CRA opinions that help reduce uncertainty for investors also help reduce the cost of capital for issuers. Lenders and investors in fixed-income securities, by contrast, use CRA ratings in assessing the likely risks they face when lending money to or investing in the securities of a particular issuer. Institutional investors and fiduciary investors (i.e., those with independent authority to invest on behalf of others, such as the managers of trust funds or pensions), likewise, use CRA ratings to help them allocate investments in a diversified risk portfolio. Government regulators also may use CRA ratings for a variety of purposes, including setting capital charges for financial institutions according to the risks attendant to the institutions' various investments.

The IOSCO Technical Committee formed a Task Force to examine certain key issues regarding the role CRAs play in securities markets.<sup>3</sup> In particular, the Technical Committee charged the Task Force with assessing:

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<sup>1</sup> Fixed-income securities are a particular form of financial obligation that may be publicly traded. CRAs may provide credit ratings for different types of debts and financial obligations — including, for example, private loans and debt securities that are not publicly tradable, as well as zero-coupon bonds, preferred shares and other securities that offer a fixed rate of return. This Report focuses on CRA activities as they relate to ratings of publicly traded debt securities and financial obligations and, for simplicity's sake, uses the term “fixed-income securities” to refer to bonds, debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

<sup>2</sup> Occasionally this report uses the terms “lender” and “investors in fixed-income securities” in a similar fashion. Although not all lenders are investors in fixed-income securities, both lenders and investors in such securities provide capital to a borrower/issuer in exchange for a pre-determined rate of return. This contrasts with investors in equity securities, who, in exchange for their capital, purchase ownership in the issuer and have a right to share in the issuer's profits after all other financial obligations are settled.

<sup>3</sup> The Task Force was chaired by Commissioner Roel C. Campos of the US Securities and Exchange Commission, and its members included representatives from: the Australian Securities and Investment Commission (Australia); the Comissão de Valores Mobiliários (Brazil); the Commission des opérations de bourse (France); the Bundesanstalt für Finanzdienstleistungsaufsicht (Germany); the Securities and Futures Commission (Hong Kong); the Commissione Nazionale per le Società e la Borsa (Italy); the Financial Services Agency (Japan); the Comisión Nacional Bancaria y de Valores (Mexico); the Ontario Securities Commission (Ontario, Canada); the Comissão do Mercado de Valores Mobiliários (Portugal); the Comisión Nacional del

- Whether CRAs disclose information about their decisions and rating criteria and whether the amount and quality of the information disclosed is sufficient for making investment decisions;
- How, when and to whom CRAs disseminate their rating decisions, and how CRAs protect against the misuse and unauthorized disclosure of nonpublic information;
- The types of conflicts of interest CRAs face and how these conflicts of interest can be prevented or managed;
- The types of regulatory oversight to which CRAs are subject, the effectiveness of this oversight, and the types of qualifications regulators require of CRAs; and,
- Whether there are barriers in the regulatory framework to entry into the credit rating business, whether such barriers have an impact on the quality of CRA ratings, and whether the barriers can be reduced.

As an initial undertaking, the Task Force drafted a questionnaire designed to ascertain detailed information about how CRAs operate in different jurisdictions. This questionnaire was circulated among the Task Force members. In addition, because a handful of the largest CRAs operate internationally, the Task Force also requested that Moody's Investor Services, Inc. (Moody's), Standard & Poor's, Inc. (S&P), Fitch, Inc. (Fitch) and Dominion Bond Rating Service, Inc. (DBRS) provide answers to portions of the Task Force questionnaire as well.

Following an analysis of the information the questionnaire generated, the Task Force met with representatives from the Basel Committee on Banking Supervision to seek input from banking regulators regarding their own interests in CRA activities. The Task Force also met with senior representatives from the four international CRAs that provided answers to the questionnaire, in order for the Technical Committee to gain a better understanding of how CRAs operate in a cross-border environment and address certain key issues of interest to IOSCO. This report and the related Technical Committee's Statement of Principles Regarding the Activities of Credit Rating Agencies is the culmination of this work.

**This report does not propose a preferred method for addressing CRA-related issues. Nor does this report endorse any particular regulatory approach jurisdictions may take regarding CRAs. Moreover, the report does not make judgments regarding the methodologies, approaches or business models CRAs may use. Rather, this report discusses certain key issues that securities regulators, CRAs and others may wish to consider when deliberating policy choices in this area. While some jurisdictions may decide to address the issues highlighted in this report through market mechanisms, others may decide to consider regulatory or other methods to address them.**

Section II of this report briefly describes what CRAs do, the different types of CRAs, and provides an overview of the rating process. Section III describes the CRA questionnaire and summarizes the responses the Task Force received. Section IV is an overview of key issues, including areas that regulators, CRAs and others may wish to consider when contemplating how to address matters relating to CRA activities. Section V concludes by

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Mercado de Valores (Spain); the Financial Services Authority (United Kingdom); and the Securities and Exchange Commission (United States).

briefly describing the IOSCO Statement of Principles and how the principles are designed to address the key issues listed in Section IV.

## **II. THE ROLE OF CREDIT RATING AGENCIES**

### ***A. What Credit Rating Agencies Do***

A credit rating is an assessment of how likely an issuer is to make timely payments on a financial obligation. Where investors believe uncertainty or broad information asymmetries exist, they typically insist on being compensated for the risks they take. This compensation — which, for fixed-income securities, usually translates into higher interest rates — increases the cost of capital for issuers of such securities.

CRA's can provide a service to both investors and issuers by redressing some of the information asymmetry. They do this by, among other things, reviewing information from a variety of sources regarding the issuer, the market in which the issuer operates, the overall economy, and the nature of the security. Because issuers may issue different types of fixed-income securities — for example, long-term or short-term instruments representing senior or subordinated debt — different securities by the same issuer may well have different credit ratings according to their differing risk profiles. All in all, CRA ratings help investors better understand the risks and uncertainties they face when investing in a given debt security, while lowering the costs of raising capital for issuers.

In contrast to public and private credit registries (or credit bureaus), which help investors overcome some information asymmetries by providing them with information about an issuer's credit history, CRA's generally engage in additional analysis of current and prospective factors that may also affect credit risk in the future. In this regard, by researching and analyzing information from a host of disparate sources, CRA's can resemble securities analysts. Like securities analysts, CRA's play an important role in the relationship between investors (including institutional lenders) and issuers and can contribute to the market's overall understanding of the vast volume of raw data that investors will wish to digest in order to make informed decisions. However, unlike many securities analysts, CRA's typically do not opine on whether a particular debt security should be bought, sold or held. Nor does a credit rating give an opinion on the value of an issuer's equity securities. Rather, credit rating categories typically reflect the CRA's assessment of the likelihood that the issuer will default on its financial obligations generally (in the case of an issuer rating) or default on a particular debt or fixed-income security. Such an opinion does not necessarily reflect an opinion on the value of a given security.

The value investors place on a given CRA's opinion necessarily depends on the reputation of the CRA itself. This reputation can depend on many things, arguably including factors that may not be directly linked to a CRA's accuracy at predicting default rates. Nonetheless, if a CRA's reputation for timeliness and accuracy were to suffer, the value investors' place on its ratings would also suffer.

## ***B. Types of Credit Rating Agencies***

Currently, there are several dozen CRAs of all types operating in major markets throughout the world.<sup>4</sup> These CRAs vary considerably in their size, focus and methodologies. Some CRAs are specialized, focusing on particular regions or industries (e.g., insurance). Others offer credit ratings on firms (including privately-held companies), but do not rate the credit risks of specific fixed-income securities. In some cases, regional CRAs in developing markets (or the local affiliates of larger international CRAs) offer an important service by analyzing local gradations of issuer credit risk that may otherwise be overwhelmed or obscured by the “country risk” (e.g., currency exchange-rate risk, political risk, etc.) that all issuers on that market face.

Three of the largest CRAs — Moody’s, S&P, and Fitch — operate internationally. These three CRAs offer credit ratings both for corporate and sovereign issuers, and specific fixed-income securities. Unlike many smaller CRAs, which generate revenue by offering their ratings to investors on a subscription basis, Moody’s, S&P and Fitch generate the bulk of their income by charging issuers for ratings, ratings that are then provided to the public free-of-charge.<sup>5</sup>

In addition to issuing credit ratings, some CRAs also offer ancillary business services or are themselves affiliates of larger corporations offering broader business services. These ancillary services include, for example, ratings assessment services where, for a fee, issuers present hypothetical scenarios to the CRA to determine how their credit rating might be affected by a proposed business activity. Other services may include risk management and consulting services to help financial institutions and other firms manage credit and operational risk. Where CRAs are part of larger business enterprises, the services provided by the larger group may or may not be directly related to the credit rating business.<sup>6</sup>

## ***C. The Rating Process***

The processes used by CRAs vary widely, depending on the CRA itself and the methodologies used. Some CRAs (including many of the larger CRAs) rely heavily on a process whereby analysts form an assessment based on quantitative and qualitative indicators and then report this assessment to a rating committee. Other CRAs emphasize quantitative models, where the assessment process is more mechanical in nature and based on statistical analysis of an issuer’s financial disclosures to arrive at a rating. In some cases, the exact processes used by a CRA may be proprietary. It is important to note that no one method is necessarily superior to another and that any consideration of the activities of CRAs should recognize that new developments (e.g., technological, statistical, or methodological) may yield new and different approaches in the future.

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<sup>4</sup> A recent Basel Committee survey of credit ratings agencies suggested there are more than 130 rating agencies world-wide. See “Credit Ratings and Complimentary Sources of Credit Quality Information,” Basel Committee on Banking Supervision Working Papers (August 2000).

<sup>5</sup> Moody’s, S&P and Fitch make public their ratings and outlines of the reasons for their ratings through press releases and reports published on their respective websites. However, only subscribers to their services are provided with full reports detailing how a ratings decision was determined.

<sup>6</sup> For example, The McGraw-Hill Companies, in addition to owning S&P, also publishes education textbooks and periodicals such as *BusinessWeek* and *Aviation Week*. FIMALAC, a Paris-based diversified services group that owns Fitch, Inc., has subsidiaries involved in industries ranging from financial services to tool manufacturing, furniture design and chemical storage.

Despite the various approaches that CRAs may take in rating issuers, the largest international CRAs tend to follow similar rating procedures for similar types of instruments. The rating process itself is designed to facilitate analytical consistency and capitalize on area expertise. At the core of the rating process used by the larger international CRAs is a rating committee. Rating committees are generally formed as required to initiate, withdraw or change a rating. They typically are composed of a lead analyst, managing directors or supervisors, and junior analytical staff. Rating decisions are made upon a simple majority vote of the committee and represent the CRA's opinion regarding the likelihood the issuer will repay its financial obligations.

At the start of the rating process, the CRA will assign a lead analyst to prepare the rating. The analyst requests information from the issuer and researches other available sources for information to provide the analyst with a better understanding of the issuer and its industry/economic environment. Analysts typically meet with senior management (or government officials, if the issuer is a government entity) and visit the issuer's offices. The analyst will then prepare a draft report and recommendation with respect to the issuer and/or its securities. This report is submitted to the rating committee, which then assigns the credit rating.

Once the rating committee decides on a rating, the analyst typically informs the issuer of the rating and may provide the issuer with a draft of the rating press release and/or report so that the issuer can review it for factual verification and, to the extent the rating release/report will be made publicly available, to ensure that no non-public information originally provided by the issuer is disclosed that the issuer wishes to keep confidential. If the issuer disagrees with the proposed rating, it can request that the rating committee reconsider its decision. However, CRAs may be reluctant to reconsider a decision unless the issuer presents new material information or points out the CRAs reliance on incorrect information.

After comments are received from the issuer and any appropriate changes made, the larger CRAs will issue press releases containing the rating and the rationale behind it. The CRA will generally continue to monitor the issuer and/or its securities on an ongoing, albeit less intensive, level and continue to meet with senior management/officials on a periodic basis.

### **III. OVERVIEW OF CRA QUESTIONNAIRE AND QUESTIONNAIRE RESPONSES**

Relatively early in its work, the Task Force drafted a 25-question questionnaire and circulated it among its members in order to obtain a better understanding of how CRAs operate in different IOSCO jurisdictions. This questionnaire was also provided to four CRAs (Moody's, S&P, Fitch and Dominion Bond Rating Service) with international operations. Responses from the Task Force members and from the CRAs greatly furthered the Technical Committee's understanding of the issues related to CRA activities in the various jurisdictions and in a cross-border financial environment.

#### ***A. The Questionnaire***

The CRA questionnaire was divided in nine parts, collectively designed to provide a detailed picture of CRA operations in different jurisdictions, the types of regulations that

exist regarding CRA activities, the uses to which CRA ratings are put, and potential regulatory issues that may exist regarding these activities and uses.

Section 1 of the questionnaire asked for general information about the type, size and number of CRAs operating in each jurisdiction. Section 2 asked about how CRAs in each jurisdiction are regulated and whether a specific agency exercised oversight authority over CRAs. Section 3 asked about how CRA ratings are used, including whether CRA ratings were used for any regulatory purposes. Section 4 asked whether any regulatory recognition criteria for CRAs existed in the jurisdiction, while Section 5 asked about barriers to market entry for new CRAs. Section 6 investigated in more detail how CRAs operate in each jurisdiction, how the rating process works and how ratings are disseminated. Section 7 asked for additional details regarding the transparency of the rating process. Section 8 inquired regarding how CRAs and CRA staff are compensated in each jurisdiction, while Section 9 asked about specific and general conflicts of interests that may influence the rating process and how CRAs in each jurisdiction addressed these conflicts.

## ***B. Summary of Questionnaire Responses***

The following is a summary of the key points derived from responses to the CRA questionnaire.

### *1. CRA Operations in Task Force Jurisdictions*

The Task Force found that the largest three international CRAs — Moody's, S&P and Fitch — have offices or affiliates in almost all of the Task Force jurisdictions. In some jurisdictions, Moody's, S&P and Fitch are the only CRAs doing business. However, several jurisdictions have a number of smaller competing CRAs as well, some of which also operate internationally.

### *2. CRA Oversight*

The majority of Task Force members indicated that no particular government agency in their jurisdiction exercises oversight authority over CRAs as such. However, members indicated that CRAs operating in their jurisdictions are nonetheless subject to a variety of securities and financial regulations and statutes, particularly those prohibiting fraud, market manipulation and market misconduct. Furthermore, in some jurisdictions, many CRAs voluntarily register with a financial regulator as advisers and one jurisdiction is considering making registration mandatory.

### *3. Users of CRA Ratings*

The questionnaire responses indicated that credit ratings are used by a wide variety of market participants for a variety of reasons. Principal users of CRA ratings include:

Issuers. Issuers value credit ratings because they lower the costs issuers pay for capital. Credit ratings reassure investors both about the risks they face when making an investment and by serving to reassure them about the competence and responsibility of management. Where investors are reassured, they tend to demand lower returns on their investments.

Investors in Fixed-Income Securities. Investors frequently use credit ratings when assessing whether to purchase a given debt security. If investors respect the opinions of a particular CRA, investors may rely on a given rating as an estimate of the risk a particular investment presents. Credit ratings in such situations act as a proxy for or a check against investors' own research and analysis of the risks related to a particular debt security. In many cases, investors seek ratings from more than one CRA regarding the same issuer.

Institutional Investors. Institutional investors and other buy-side firms such as collective investment schemes, pension funds and insurance companies tend to be among the largest purchasers of fixed-income securities in many jurisdictions and, in many jurisdictions, investors in fixed-income securities are almost exclusively institutions. Although institutional investors frequently employ their own analysts and conduct their own credit analyses of issuers and securities, they also frequently rely on CRAs to support or refute their own assessments.

Institutional investors may also use credit ratings to comply with internal investment restrictions or policies that require the firm to maintain certain minimum credit ratings for investments, or to identify acceptable counterparties. They may also use credit ratings to construct bond indices against which they monitor the performance of fund managers or index mutual funds.

Depending on the jurisdiction, institutional investors may also rely on credit ratings to comply with certain regulatory requirements.

Equity Investors. Although CRAs are not equity analysts and credit ratings are not substitutes for equity research, equity investors as well may use credit ratings as one of many factors when deciding whether to purchase a company's equity securities. Issuer default rates are not necessarily tied to the desirability of an issuer's equity securities — for example, a company facing little risk of defaulting on a fixed-income security may still see the price of its equity securities decline as its business environment changes. However, equity investors may be interested in the opinions CRAs have regarding an issuer's likelihood of defaulting on its debts, and may use these opinions in their own assessments of an equity security's value.

Broker-Dealers and Sell-Side Firms. Many brokerage companies and other sell-side firms (i.e., investment firms that make recommendations and sell securities to clients) engage in their own credit analysis for risk management and trading purposes. As with institutional investors, broker-dealers and investment advisors may use CRA ratings as a check against their own research and recommendations. Likewise, bond analysts at sell-side firms may use credit ratings in their overall assessment of whether to recommend buying, selling or holding the fixed-income securities of an issuer.

Underwriters and investment banks also advise issuers in selecting appropriate CRAs to rate a fixed-income securities offering. These firms may also offer rating advisory services designed to assist underwriting clients throughout the rating process.

In some markets, broker-dealers may use credit ratings to determine acceptable counterparties and set collateral levels for outstanding credit exposures.

Regulators. Financial regulators in many jurisdictions increasingly appear to use credit ratings for a variety of purposes. These uses vary from setting capital requirements for banks and other financial institutions to rules governing money markets funds, pension funds and collective investment schemes, and in regulating asset-backed securities. Recently, the Basel Committee on Banking Supervision proposed permitting banks to use ratings from CRAs in determining capital requirements under the new Basel Capital Accord.<sup>7</sup>

A few Task Force members noted that credit ratings are also used in setting real estate and insurance regulations.

Use by Private Parties. Creditors and other businesses may use CRA ratings in private contracts for a variety of purposes. Among the most prominent of these uses are “ratings triggers” in financial contracts. In many secured or structured financial agreements, counterparties and lenders are given the right to accelerate repayment of an outstanding loan, or have the borrower post collateral, if the rating of the borrower’s fixed-income securities falls below a certain level. Counterparties and lenders sometimes demand these clauses in order to help them secure collateral and recover prospective losses in cases where a borrower faces a serious likelihood of bankruptcy or default.

#### 4. Regulatory Recognition Criteria

While Task Force members noted that credit ratings are frequently used for certain regulatory purposes, there are differences in how specific CRAs are recognized for these purposes. A few jurisdictions impose no recognition criteria other than that the CRA must operate in the jurisdiction in question. Other Task Force members recognize (on either a formal or informal basis) a certain number of CRAs for regulatory purposes. Where CRAs are used for regulatory purposes, Task Force members base their recognition decisions on a variety of criteria, perhaps the most significant of which is a particular CRA’s credibility with international or domestic market participants. Other factors considered in various jurisdictions include: demonstration that the CRA appropriately manages real and potential conflicts of interest; transparency and robustness in the CRA’s rating methodology; minimum personnel proficiency and training requirements; minimum resource (staff and financial) requirements; recognition by foreign financial regulators; and/or rating performance equivalent to certain international CRA benchmarks.

The Basel Committee on Banking Supervision recently proposed a set of recognition criteria in its new Basel Capital Accord that banking regulators may use when determining whether ratings from a particular CRA may be used for setting bank capital requirements. These eligibility criteria focus on six factors, including a CRA’s objectivity, independence, transparency, disclosure policies, resources, and credibility with independent market participants. A number of Task Force members indicated that these eligibility criteria might be incorporated into their own recognition requirements in the future.

#### 5. Barriers to Market Entry

Because much of the international credit rating “business” is dominated by the three largest CRAs (Moody’s, S&P and Fitch), some commentators have claimed that various

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<sup>7</sup> The New Basel Capital Accord (April 2003), Pillar 2: External Credit Assessments.

barriers to market entry unfairly limit competition in the CRA industry. Consequently, the Task Force questionnaire asked what, if any, factors exist in Task Force jurisdictions that may act as barriers to a new CRA entrants.

For the most part, Task Force members noted that CRAs are not extensively regulated and those regulations that do exist are not onerous for new entrants. However, several Task Force members noted that the nature of the CRA “market” makes it difficult for new CRA entrants to succeed. According to these members, issuers desire ratings from only those CRAs respected by investors. On the other hand, investors respect only those CRAs with a reputation for accuracy and timeliness in issuing credit ratings. Establishing such a reputation can take considerable time and resources. Furthermore, some commentators have suggested that issuers may prefer to retain, and investors may prefer to use the opinions of, CRAs that a government regulator or agency also uses. Where government CRA recognition criteria are based on how extensively a CRA’s opinions are used by issuers and investors, such a situation arguably may discriminate against new entrants, with regulatory recognition being based on reliance by the market, and market reliance being influenced by regulatory recognition.

#### 6. Ratings Disclosure and Publication

As noted above, the largest CRAs make public their ratings decisions regarding publicly issued fixed-income securities.<sup>8</sup> While these CRAs may provide subscribers to their services with more elaborate reports detailing the reasons behind the CRAs’ decisions, subscribers are not provided with rating decisions or the rating reports prior to the CRA publicly issuing its rating decision. Rather than rely on subscriber fees, the largest CRAs receive the bulk of their revenue from fees they charge issuers in return for a rating.

Many smaller and more specialized CRAs, on the other hand, do not charge issuers for their ratings and instead rely on subscriber fees. Because larger issuers may be unwilling to request a rating from a smaller and relatively unknown CRA (particularly where the issuer is already rated by one or more of the larger ratings firms), many of these smaller CRAs issue unsolicited ratings as a way of building their reputations.

Task Force members differ on whether issuers are required to publicly disclose credit ratings in their prospectuses or regulatory filings. Some jurisdictions require ratings to be disclosed by the issuer where these ratings exist, while others require disclosure only where a rating is a regulatory requirement. Other members, however, indicated issuers are not required to disclose credit ratings at all, while still others required disclosure only insofar as a credit rating is deemed likely to have a “material” impact on the price of the security or if the information is deemed “material information” that a shareholder is likely view as important to making an investment decision. Several questionnaire responses indicated that most issuers in that jurisdiction voluntarily disclose credit ratings regardless of a lack of a regulatory requirement.

Most Task Force members indicated that, presently, there are no requirements regarding when CRAs may issue their ratings. The four CRA responses to the questionnaire stated that their practices are to disseminate a rating as soon as practicable after a rating

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<sup>8</sup> Some CRAs conduct credit risk analyses for private loan transactions, in addition to issuing ratings on publicly-trade fixed-income securities. Ratings for these private transactions typically are not made public.

decision has been made and after the issuer has verified that no incorrect or confidential information is contained in the rating press release.

#### 7. Rating Methodologies and Transparency

Because CRAs differ by size and specialization, the rating processes and methodologies they use can vary. The rating process used by the largest CRAs is described in Section IV of this Report.

Most Task Force members stated that there are no requirements regarding what CRAs must disclose when issuing a rating. Nonetheless, the larger CRAs typically publish the methodologies they use when rating specific industries, industry sectors and regional sub-sectors. These CRAs also publish default studies that describe the correlation between rating categories and default rates over a given period. The press release that accompanies a rating also typically lists the key assumptions upon which a rating is based.

Task Force members also noted that, while regulations do not require that CRAs provide issuers with a right to review a rating prior to its publication, most CRAs usually allow issuers to review a rating and press release in order to correct any errors and confirm that no non-public information is being released. Further, some CRAs have an appeal process whereby issuers can present reasons why a rating may be incorrect or fail to take into consideration relevant factors.

Several questionnaire respondents stated that some CRAs publish the names and telephone numbers of analysts assigned to review an issuer or security and that these analysts are available to answer questions from the public, regardless of whether or not that person has a subscription to the CRA's services.

#### 8. CRA and CRA Staff Compensation

In most Task Force jurisdictions, larger CRAs tend to receive most of their revenue through fees paid by issuers, with a much smaller percentage of revenue made up of subscription sales. The fees CRAs charge issuers vary according to the CRA, but usually take into account the size and type of issuer and the complexity of the issuance.

Smaller CRAs tend to receive most of their revenue through subscription sales.

Questionnaire respondents also indicated that CRA analysts usually are paid a fixed salary plus an annual bonus. Salaries tend to be based on individual qualifications and experience, while bonuses tend to be linked to merit criteria. CRA respondents to the questionnaire indicated that the compensation of CRA analysts is not linked to the amount of revenue a particular issuer generates for the CRA.

#### 9. Conflicts of Interest

Task Force members cited several potential areas where conflicts of interest may arise regarding the activities of CRAs. The most common include:

Issuer fees. The most common conflict of interest cited by Task Force members was that larger CRAs receive most of their revenue from the issuers that they rate. Where a CRA receives revenue from an issuer, the CRA may be inclined to downplay the credit risk it poses in order to retain the issuer's business. The CRAs responding to

the Task Force's questionnaire stated that they are aware of this potential conflict of interest and attempt to mitigate its influence by ensuring that no particular issuer constitutes any significant portion of the CRA's overall revenue. These firms claim that, because credit ratings from a particular firm are only valuable insofar as the firm maintains a reputation for independence, accuracy and thoroughness, CRAs would be unwilling to risk damaging their reputations just to retain a single client. Furthermore, while issuers may prefer to use a credit rating from a firm with relatively lax rating standards, investors are unlikely to accord such ratings much weight and the issuer would pay higher costs for the capital it is trying to raise.

CRAs also note that CRA analyst compensation is not linked to issuer fees. According to the CRA respondents, this, combined with the use of rating committees, removes the likelihood that the rating process will be inappropriately influenced.

Access to Non-Public Information/Insider Trading. A few Task Force members indicated that a CRA's access to non-public information is itself a potential conflict of interest, insofar as CRA staff may be tempted to use the information to trade securities on their own account. The largest CRAs attempt to manage this potential conflict by adopting internal procedural safeguards to protect non-public information and by restricting or prohibiting CRA staff from engaging in financial activities (including securities trading) where a conflict of interest may arise.

Ancillary Advisory Services. A few Task Force members noted that offering ancillary business services also raised potential conflicts of interest issues. According to these members, a CRA's rating decisions could be influenced by whether or not an issuer purchases additional services offered by the CRA. In addition, regardless of whether or not the purchase of ancillary services has an impact on a rating decision, issuers may be pressured into using these services out of fear that their failure to do so could adversely impact their credit rating (or, conversely, that purchasing the service could improve a rating).

The CRAs responding to the Task Force questionnaire also noted these concerns. They stated that they attempt to address these concerns by (1) not offering ancillary services at all; (2) establishing robust information barriers or corporate "firewalls" between CRA analysts and personnel engaged in the sale of the ancillary services; or (3) not providing ancillary services to issuers the CRA rates.

Financial Interests in Rated Issuers. Several Task Force members cited having a financial relationship in an issuer (holding shares in the issuer or being affiliated with the issuer in some way) as presenting a significant conflict of interest. The CRA respondents, however, noted that their internal policies prohibit the CRA from rating issuers in which the firm has a financial interest or from rating affiliates of the firm.

#### **IV. OVERVIEW OF KEY ISSUES FOR SECURITIES REGULATORS**

Because CRAs can play an important role in securities markets, the activities of CRAs are of interest to investors, issuers, market intermediaries, and securities regulators. Securities regulators, in particular, frequently have a dual interest in the activities of CRAs, both because CRAs may have an effect on market transparency and because some securities regulators use CRA ratings for regulatory purposes. Consequently, in addition to developing

guidance principles regarding CRA activities, the Technical Committee also expressed an interest in a review of issues that should be studied if a jurisdiction is considering whether regulatory action in this area is appropriate.

As part of its project, the Technical Committee analyzed issues of particular interest to securities regulators considering whether regulation of activities related to CRAs is appropriate. These issues may influence a regulator's decision to regulate in this area or may be factored into the shape such regulation takes.

#### ***A. CRA Independence and Conflicts of Interest***

Perhaps the single greatest concern facing CRAs is identifying and addressing potential and actual conflicts of interest that may inappropriately influence the rating process. As described in this Report, CRA conflicts of interest can vary according to the size of the CRA, the jurisdiction in which it operates, its primary sources of income, and other factors. Securities regulators, CRAs and other market participants should be aware of the nature of these conflicts and consider mechanisms by which the effects of potential and actual conflicts may be eliminated or mitigated.

#### ***B. Issuers and Disclosure***

As noted previously, CRAs perform a service to issuers as well as to investors by reducing information asymmetries, thereby lowering the cost of capital for issuers. CRAs collect and analyze information from a variety of sources. Frequently, however, the most important source of both public and non-public information about the credit worthiness of an issuer is from the issuer itself. Without sufficient and accurate information from issuers, CRAs will be unable to resolve some uncertainties, to the detriment of market transparency.

Securities regulators considering whether regulations regarding CRA activities are appropriate will wish to take into account the importance of issuer disclosure and issuer cooperation. Although many CRAs engage in a dialogue with issuers and may have access to certain non-public information, generally the framework of data around which a rating decision is based is derived from information released by the issuer in its disclosure statements. Consequently, an issuer's ongoing disclosure obligations become vitally important to the rating process. Securities regulators may wish to refer to the Technical Committee's Statement of Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities in this regard which states, among other things, that (1) listed entities have an ongoing obligation to disclose all information that would be material to an investor's investment decision; and (2) that disclosure of this information should be timely and, where the information involves material developments, immediate (or as soon as possible, if a maximum prescribed time frame is set by law or regulation).<sup>9</sup>

Similarly, when considering whether regulatory action regarding CRAs is appropriate, securities regulators (and the CRAs themselves) may wish to consider whether a threat exists of issuer manipulation of the rating process. Although issuers as a group have an interest in maintaining the integrity and transparency of securities markets generally and the rating process in particular, certain issuers or individuals associated with an issuer may desire to

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<sup>9</sup> IOSCO Public Document No. 132, *Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities*, IOSCO Technical Committee (October 2002).

manipulate the rating process in order to benefit the issuer in a particular transaction or as part of a larger market manipulation scheme. Anti-fraud and market manipulation statutes and regulations, as well as certain CRA confirmation mechanisms, may be helpful in minimizing this possibility.

Securities regulators also may wish to consider whether CRA ratings, themselves, are material information that should be made part of an issuer's ongoing disclosure obligation, or what types of ratings for what types of transactions may constitute material information that issuers should disclose.

### ***C. Public Dissemination of Ratings and Market Timing***

Financial regulators in certain jurisdictions have expressed concern regarding the timing of when rating decisions are made public. According to these concerns, rating decisions made public prior to the close of the relevant stock exchange may contribute to market volatility as investors buy or sell shares in response to the new rating, without having time to review the merits of the rating decision. Some have suggested that requiring CRAs to make public their rating decisions only once the relevant market has closed might lessen this volatility. On the other hand, securities regulators contemplating regulations in this area may wish to balance concerns about volatility against the possible effects delaying the release of such material information may have on market transparency and efficiency. Similarly, another factor weighing against such a restriction is that the "market" never closes. While trading on a particular exchange may have ended for the day, trading in an inter-listed security or a related security may be continuing in another time zone. A restriction requiring that CRA ratings be made public only once a "primary" market has closed may introduce market distortions benefiting certain investors (e.g., large institutions with sophisticated cross-border trading operations) and disadvantaging others (e.g., retail investors).

### ***D. Preferential Subscriber Access to Information***

Some critics of CRAs have expressed concern regarding special access to information that subscribers to a CRA's services may receive. According to these concerns, subscribers to a CRA's services may receive valuable analytical insights that otherwise may not be publicly disseminated. Likewise, some CRAs permit subscribers to contact their analysts to ask questions about the reasoning behind a rating decision.

Nonetheless, because CRAs differ in their business models, securities regulators may wish to consider what effects any regulatory intervention may have on different types of CRAs. Subscription services form the primary source of revenue for smaller CRAs and new entrants. Because several of the larger CRAs indicated to the Technical Committee that their analysts take questions from the public regardless of whether or not an individual subscribes to their services, restrictions on selective access may adversely affect smaller CRAs that rely on subscriptions. Likewise, larger CRAs that provide more detailed reports to subscribers may justify this selective access based on the cost of making this information available. Others analogize their subscription service to journalistic wire services used by many newspapers, noting that many of these wire services, in fact, are subscribers of CRAs and base news stories on CRA subscription reports.

Another factor some commentators have suggested regulators may wish to consider is whether CRA subscribers receive "material information" that place them at an advantage vis-

à-vis investors relying exclusively on freely available public information. This will depend on a jurisdiction's definition of "material information." While some jurisdictions with selective disclosure prohibitions explicitly exempt CRAs from this prohibition, many of these same jurisdictions only allow for this exemption if the CRA distributes the rating to the public.<sup>10</sup>

### ***E. Challenges to New CRAs***

The value investors place on the opinions and ratings of a CRA depends, to a significant extent, on the reputation that CRA has built among investors. This reputation frequently is based on a history of providing accurate, timely and useful ratings. Consequently, new CRAs can face several disadvantages to more established CRAs. These include:

A lack of a rating history. Without a history of timely and accurate ratings, a CRA may have difficulty establishing itself. Investors will be reluctant to accord the ratings of a new entrant the same regard given more established CRAs because new entrants lack historical default rates by which investors can compare its performance against other CRAs. As a result, issuers may be reluctant to engage a new entrant for a rating. Without investor or issuer interest, it may take considerable time for a CRA's rating business to become self-sustaining. Consequently, a new entrant may have to devote considerable time and expense developing a reputation among investors before it can become a viable competitor to more established CRAs.

A lack of resources and issuer access. In many (though not all) cases, a new entrant may have fewer resources (staff, analytical tools and other resources) than more established CRAs. Without these resources, a new entrant may be at a disadvantage vis-à-vis more established CRAs, who may be able to hire more staff (and more experienced staff) to analyze large issuers involved in numerous complicated transactions. Likewise, as issuers initially may express no interest in contracting with a new entrant for a rating, new entrants may be forced to build their reputation on the basis of unsolicited ratings, without the benefit of issuer cooperation and input. This last point, however, may be mitigated to some extent if ongoing issuer disclosure obligations provide sufficient information to the public that a new entrant can, through careful analysis, draw accurate and timely conclusions regarding the issuer's financial health and economic prospects.

Special conflicts of interest. Given the high start-up costs new entrants face, new CRAs may be vulnerable to financial pressures larger CRAs may be insulated against by their size. To a new entrant, a single fee-paying issuer may comprise a large portion of the CRA's overall revenue, creating a potential conflict of interest that may influence its rating decisions should the new entrant fear a loss of this business. Likewise, the large amount of capital and time necessary to establish a new entrant may necessitate an affiliation with a larger firm. As described earlier, such affiliations present their own conflicts of interest issues if the financial interests of the parent firm influence the rating decisions of the CRA affiliate.

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<sup>10</sup> For example, the U.S. Securities and Exchange Commission's "Regulation Fair Disclosure" specifically exempts CRAs from its prohibitions on selective disclosure by issuers of material non-public information, provided the CRAs use the material non-public information solely for developing a rating, and the CRAs' ratings are publicly available.

Securities authorities considering regulations regarding CRA activities may wish to take into account what effects, if any, proposed regulations or proposed oversight activities may have on new CRA entrants.

#### ***F. Unsolicited Ratings***

Unsolicited ratings potentially pose two separate issues that securities regulators may wish to evaluate if considering whether regulatory actions with regard to CRAs are appropriate.

Unsolicited ratings and issuer access. Unsolicited ratings are ratings that CRAs conduct without being formally engaged to do so by the issuer. As such, the rating process behind an unsolicited rating may lack the type of issuer input and, depending on the circumstances, access to non-public information that a solicited rating may incorporate. Consequently, investors may wish to have notice that a rating was unsolicited in order to take this fact into account when making their investment decisions.

Unsolicited ratings and potential abusive practices. In the past, some issuers have accused CRAs of using unsolicited ratings to induce issuers to engage the CRAs' services. According to these accusations, some CRAs have either submitted bills for unsolicited ratings, or have implied that an unsolicited rating could be upgraded if the CRA were engaged and had the active cooperation of (and fees from) the issuer.

Although unsolicited ratings may pose issues for securities regulators contemplating regulation in this area, regulators should also be aware that new entrants frequently rely on unsolicited ratings in order to build their reputations. Blanket prohibitions on the activity effectively may constitute a barrier to new entrants. Consequently, as the Statement of Principles notes, this issue may be best addressed through disclosure.

### **V. THE TECHNICAL COMMITTEE'S STATEMENT OF PRINCIPLES REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES**

CRAs play an important role in helping market participants incorporate into their decision-making voluminous, diverse and highly complicated information about a particular investment. Regulators, market participants and CRAs themselves have an interest in ensuring that CRAs carry out this role. Although CRAs vary widely by size, focus and markets in which they operate, the Task Force, in analyzing the information it gathered, was able to distill a set of principles that can assist CRAs in developing informed, independent ratings. Broadly, these key issues fall under four categories relating to:

- The quality and integrity of the rating process;
- CRA independence and conflicts of interest;
- The transparency and timeliness of ratings disclosure; and,
- CRA use of confidential information.

The Technical Committee’s Statement of Principles Regarding the Activities of Credit Rating Agencies, which accompanies this report, sets forth high-level objectives for which ratings agencies, regulators, issuers and other market participants should strive in order to improve investor protection and market transparency. These principles address different aspects of these four key issues. Although these principles focus on the activities of the CRAs, creating a market environment in which CRAs can most effectively offer informed, independent analyses and opinions does not depend exclusively on CRAs themselves. Other market participants — and particularly issuers — are important partners in this process.

As noted in the Statement of Principles, how these principles are given effect among IOSCO members will depend on local market circumstances and each jurisdiction’s legal system. Depending on these circumstances, the mechanisms for implementing the principles may take the form of industry codes, internal firm policies and procedures of the CRAs themselves (which have a strong interest in maintaining the integrity of the rating process) or, where deemed necessary and appropriate, government regulation.

The Technical Committee’s Statement of Principles should be considered in the context of the laws and regulations that apply in a given jurisdiction, as these laws may restrict the conduct of CRAs, issuers and other market participants.

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

The principles contained in the Technical Committee’s Statement are designed to promote investor protection and market transparency by addressing each of these four categories. In doing so, the principles are designed to promote ratings that are useful to investors and that help reduce information asymmetries between investors and issuers. The principles also are designed to encourage issuer disclosure and communication with CRAs by addressing concerns regarding the transparency of the rating process and how CRAs maintain the confidential nature of certain non-public information.

#### ***A. Quality and Integrity of the Rating Process***

At the most basic level, a credit rating’s value to investors depends on its meaning being clear and the analysis underlying the rating being sufficiently thorough to provide investors with information and insights they want when making investment decisions. Over the longer term, CRAs that fail to provide investors with analytical thoroughness, clarity and usefulness — i.e., CRAs that fail to help reduce the asymmetry of information between borrowers, lenders and other market participants — likely also will fail as businesses. Over the shorter term, however, a respected CRA that fails to maintain high standards of quality and integrity in its rating process may well provide investors with a false sense of certainty regarding the risks they face when investing in certain fixed-income securities. Rather than contributing to market transparency, such a situation could make a market less transparent.

Principles 1, and Sub-Principles 1.1-1.6, are designed to address this concern by encouraging the adoption of procedures and mechanisms promoting quality and integrity in the rating process, thereby improving the usefulness to investors of credit ratings. In particular, these principles promote mechanisms that can be used as checks against the quality of CRA ratings.

Principle 1 states that CRAs should endeavor to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants. As noted above, information asymmetries among the issuers and investors directly relate to the cost of capital that issuers must pay. Principle 1 is the perhaps the most significant of the Statement, for the other Principles, at heart, are designed to facilitate the abilities of CRAs to provide opinions and analyses that help reduce these information asymmetries. Sub-Principles 1.1 through 1.6 establish more focused objectives for CRAs in support of this basic Principle.

### ***B. Independence and Conflicts of Interest***

The respect investors give the opinions of a CRA depends, to a significant degree, on their confidence that these opinions are not inappropriately influenced by factors unrelated to a credit assessment. Conflicts of interest or factors that impinge on a CRA's analytical independence can undermine investor confidence in the CRA's opinions and ratings. Where conflicts of interest or a lack of independence are widespread and hidden from investors, overall investor confidence in the transparency and integrity of a market can be harmed.

Principles 2, and Sub-Principles 2.1-2.5, are designed to reinforce CRA analytical independence and the overall integrity of the rating process. These principles are designed to address conflicts of interest that may affect CRA staff, in addition to the CRA itself. By protecting against conflicts of interest and maintaining their analytical independence, CRAs can improve the confidence investors place in their ratings and opinions and promote transparency in the overall market.

Threats to a CRA's analytical independence — whether in the form of undue outside influence or conflicts of interest such as direct financial interests in an issuer or CRA staff trading ahead of a rating decision — call into question a CRA's ability to provide opinions that help reduce information asymmetries between issuers and investors. Consequently, Principle 2 states that CRAs should work to ensure that their independence is neither compromised nor seen as compromised. Where a CRA's independence is compromised, market transparency may suffer and, at least in the short run, investors may make investment decisions based on prejudiced information. Where a CRA's independence appears to be compromised, investors will disregard the CRA's opinions and the CRA will fail in its endeavor to reduce information asymmetries.

Principles 2.1 through 2.6 are more focused objectives that CRAs should seek to achieve in order to strengthen their analytical independence and reduce the possibility that conflicts of interest of all sorts will interfere with the rating process. These range from adopting formal mechanisms and procedures to identify actual and potential conflicts of interest and either eliminate them or mitigate their effects, to avoiding trading activities and financial relationships that may present conflicts of interest or undermine a CRA's independence.

### ***C. Transparency and Timeliness of Ratings Disclosure***

Credit ratings must be disclosed on a timely basis to be useful to investors. Likewise, transparency in the rating process — providing investors and issuers with information about the procedures, methodologies and assumptions that result in a credit rating — benefits both investors and issuers. Investors are given information to help assess the quality of a CRA's opinion for the purposes of their investment decision-making. Issuers, on the other hand, are

reassured of the fairness of the rating process and encouraged to provide issuers with the information CRAs need in forming their opinions.

Principles 3, and Sub-Principles 3.1-3.5, are designed to help provide investors with timely information about a rating and the procedures, methodologies and assumptions behind a rating. The principles are also designed to help provide investors with information they can use in assessing the quality of a CRA's opinions, such as historical default rates for rating categories and whether a given rating was unsolicited (and potentially made without input from or the cooperation of the issuer). This set of principles is also designed to encourage issuer cooperation with CRAs by reassuring them of the fairness and objectivity of the rating process.

Principle 3, stating that disclosure and transparency should be objectives in the rating process, directly supports Principle 1. Sub-Principles 3.1 through 3.5 list more focused objectives that CRAs should seek in order to protect the ratings process from undue outside influence, provide investors with sufficient information to help them make better-informed investment decisions, and provide issuers with sufficient information about the rating process so that they, in turn, are encourage to provide CRAs with information that assists them in forming their opinions.

Sub-Principle 3.2 states that CRAs that use material non-public information when assigning a rating to publicly traded fixed-income securities should make those ratings public. This Sub-Principle recognizes that different CRAs rely on different business models, some of which may be subscription-based. Likewise, CRAs may use material non-public information provided to them by an issuer when developing a non-public rating for a private loan or similar private transaction. However, where CRAs have access to material non-public information and use this information in developing a rating for publicly trade debt or securities, this special access to material non-public information should serve to enhance overall market transparency.

#### ***D. Confidential Information***

In many cases, issuers may have a greater understanding of the risk factors relating to a fixed-income security than do investors themselves. Widespread information asymmetries of this sort tend to raise the cost of capital for issuers, as investors insist on being compensated for the uncertainty these asymmetries cause. CRAs can help lower the cost of capital for issuers by working to reduce these information asymmetries. CRAs may do this by analyzing publicly available information or by directly asking the issuer questions about its operations, management, and financial situation. However, issuers may be reluctant to share with CRAs non-public but potentially relevant information if issuers are concerned that the information will not remain confidential or will be used in a manner other than relating to a credit rating.

Principle 4, and Sub-Principles 4.1 and 4.2, are designed to encourage issuer cooperation with CRAs by promoting procedures and mechanisms to protect non-public information from premature disclosure or by use in ways unrelated to a CRA's rating activities.

Principle 4, and Sub-Principles 4.1 and 4.2, which require CRAs to maintain in confidence material provided to them under the terms of a confidentiality agreement, are not meant to prejudice the obligations issuers themselves have to disclose material information.

As discussed in the Technical Committee's Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities, issuers have independent obligations to disclose certain information and Principle 4 and its Sub-Principles are not to be construed as altering these obligations.

Similarly, Principle 4 and its Sub-Principles should not be construed as encouraging CRAs to sign confidentiality agreements that limit their abilities to report on material developments regarding the issuer they are rating. Several CRAs have indicated to the Technical Committee that they, as a matter of policy, refuse to sign non-disclosure agreements of a sort that limit their rights to discuss in their reports material, albeit non-public, information. The Technical Committee encourages CRAs to evaluate for themselves whether such confidentiality agreements enhance or inhibit their abilities to reduce information asymmetries between issuers and investors.