OICV-IOSCO
30th Annual Conference
2005, Colombo–Sri Lanka

Plenary 1

The Regulation of Credit rating Agencies

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6 April 2005

STANDARD & POOR'S

Regulation of European Agencies: an International Perspective

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The McGraw-Hill Companies

CRAs: An extended role generating growing attention from markets and regulators

A secular trend: credit ratings have grown in importance for international debt and capital markets

- Desintermediation, internationalization and growing sophistication of credit markets (structured finance…)
- Interaction between debt and equity

Specific but far-reaching corporate fraud has challenged the credibility of financial information and indirectly financial analysis

- Enron, Worldcom in the US
- Parmalat in Europe…

Specific rating actions have had an important impact in a difficult economic and financial environment

- “the technology bubble” has ended up with rapidly deteriorating credit quality
- Pension liabilities have become an increased source of concern
- Credit risk deterioration has impacted equity prices
- Specific market practices refer to credit ratings and have increased rating impact (e.g. rating triggers)
- International CRA’s decisions have a growing impact in domestic markets, and are often challenged by non-financial stakeholders, including politicians

What regulatory framework for credit rating agencies? A complex issue

The growing role of credit ratings reflects self-supported market demand for independent and objective opinions on credit risk

Markets “rate the raters” every day, and loss of credibility would threaten the mere existence of rating agencies

Ratings must be based on independence, credibility and expertise, and cannot be “content-regulated”

Plurality of opinions is necessary, but the resources needed to perform high-quality ratings probably drive to some concentration

The important and growing role of credit ratings in capital markets worldwide create specific accountability for rating agencies, including to be transparent on their practices and processes

Ratings are increasingly used, directly or indirectly, for regulatory purposes (e.g. Basel 2…)

While rating decisions are by essence debatable, commenters on CRAs’ ratings performance have noted their excellent track record.

Intense regulatory review with active participation from market professionals

In the US

- SEC and Congress

In Europe

- European Parliament (Katifioris Report)
- European Commission
- CESR (Technical advice April 2005)

At the international level

- G7 and Forum for Financial Stability
- IOSCO: Principles of conduct for Credit Rating agencies (Sept. 2003) and Code of Conduct (Dec. 2004)

Active contribution from users of credit ratings

- Issuers (cf. AFO/ACT/AFTE) intermediaries and investors

Final resolution still a work in progress…key market participants have confirmed the ongoing efficient and effective use of market-based acceptance and oversight.

Principles of CRA’s market accountability

Independence and objectivity of rating opinions are critical for CRA’s to play their role

Maintaining the integrity of the rating process

- Analytical expertise: qualification and training of analytical teams, ratings performance tracking through default statistics and transition matrix
- Clearly defined rating process (rating team, preservation of confidential information, rating committee…)
- Prevention of conflicts of interest
  - Individual behavior of rating and CRA’s staff
  - Separation between rating and non-rating business through effective firewalls

Informing issuers and markets appropriately

- Individual rating decisions
- Criteria and methodology

S&P’s support to IOSCO approach

S&P has been actively involved in the discussions at IOSCO and strongly support the implementation of the principles in IOSCO Code of Conduct on a self-regulatory “comply or explain” approach

- Market-oriented solution
- Addresses genuine issues in a pragmatic fashion (“Comply or explain”) facilitating a common language between stakeholders, also at the international level
- Comforts analytical independence, but requests comprehensive disclosure
- Supported by the overwhelming majority of rating users

Provisions of S&P Sep. 2004 “Code of Practices and Processes” consistent with IOSCO Code

- Compilation in a single source of long-existing practices
- Mapping with IOSCO underway, with few and minor divergences