



## **FINANCIAL SERVICES COMMISSION**

**Wednesday, November 24, 2004**

### **Discussion Paper: Guidelines for Regulatory Oversight of Credit Rating Agencies**

#### **BACKGROUND:**

The creation of Caribbean Information & Credit Rating Services Limited (“CariCRIS”), an independent credit rating organisation, is a significant development for the region’s financial and capital markets. This organisation plans to provide credit ratings for corporations and governments on a national and regional scale. The Financial Services Commission (“FSC”) expects that opinions issued by CariCRIS will have a growing influence on the markets as credit ratings signal the future creditworthiness of rated entities.

In addition, based on the experience in many different jurisdictions, credit ratings can become incorporated in the regulatory process. As an example, the Securities and Exchange Commission of the United States (“USSEC”), provides “a method for determining capital charges on different grades of debt securities under the Commission’s net capital rule for broker-dealers, Rule 15c3-1 under the Securities Exchange Act of 1934 (the “Net Capital Rule”).”<sup>1</sup> The Net Capital Rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions—commonly referred to as ‘haircuts.’ A lower haircut is applied to securities that are rated investment grade by a nationally recognised rating agency because those securities are considered to be more liquid and less volatile in price than securities that are not so highly rated.<sup>2</sup>

Under the FSC’s current guidelines for Interim Capital Adequacy, securities dealers are required to calculate their minimum capital based on prescribed risk weightings of the various securities held. Going forward, the ratings provided by independent and nationally recognised rating agencies could be incorporated into these guidelines, thus making the process dynamic and more reflective of the changing risk profiles of securities held.

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<sup>1</sup> SEC Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws

<sup>2</sup> SEC Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws

**PROPOSED REGULATORY MODEL:**

Against this background, the FSC proposes to adopt as a regulatory model a process of recognising and de-recognising credit rating agencies. This would consist of:

- A. An initial assessment based on several elements listed below, thus allowing the regulator to formally recognise new entrant credit rating agencies.
- B. Periodic reviews to verify adherence to regulatory requirements as outlined below. (Non-adherence would be a basis for de-recognition.)
- C. Disclosure requirements.

**A. Initial Regulatory Assessment of New Entrant Credit Rating Agency<sup>3</sup>**

The regulatory process of recognizing a new entrant credit rating agency would be conditioned on an assessment of the following:

1. The organisational structure of the rating organisation (composition of the board of directors, shareholder structure);
2. The rating organisation's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates);
3. The size and experience and training of the rating organisation's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit);
4. The rating organisation's independence from the companies it rates;
5. The rating organisation's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and
6. Whether the rating organisation has internal procedures to prevent the misuse of non-public information and how those procedures are followed.

In addition to the above, for new entrant credit rating agencies that have been operating in other national markets, the FSC would determine whether the rating agencies are 'nationally recognised' in their home market as an issuer of credible and reliable ratings by their regulators as well as the predominant users of securities ratings.

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<sup>3</sup> Adopted from "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," January 2003, Securities and Exchange Commission of the United States, SEC

## B. Periodic Regulatory Review of Credit Rating Agencies

Periodic regulatory review of nationally recognised credit rating agencies would be guided by core principles<sup>4</sup>. The FSC proposes that these principles be given effect through regulatory requirements and become a part of the internal rating agency policies and procedures.

1. **Quality and Integrity of the Rating Process** – Credit Rating Agencies must endeavour to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants.
  - 1.1. Credit Rating Agencies must adopt and implement written procedures and methodologies to ensure that the opinions they issue are based on fair and thorough analysis of all relevant information available to the Credit Rating Agency, and that Credit Rating Agency analysts perform their duties with integrity. Credit Rating Agency rating methodologies must be rigorous, systematic and Credit Rating Agency ratings must be subject to some form of validation based on historical experience.
  - 1.2. Credit Rating Agencies must monitor on an ongoing basis and regularly update an analysis and rating once a rating is issued whenever new information becomes available that causes the rating agency to revise or terminate its opinion.
  - 1.3. Credit Rating Agencies must maintain internal records to support their ratings.
  - 1.4. Credit Rating Agencies must have sufficient resources to carry out high-quality credit assessments. They should have sufficient personnel to properly assess the entities they rate, seek out information they need in order to make an assessment, and analyse all the information relevant to their decision-making processes. (An example of insufficient resources would be a credit rating analyst who doubles as the salesperson making the sales pitch to companies.)
  - 1.5. Analysts employed by rating agencies must use the methodologies established by the Credit Rating Agency and be professional, competent, and of high integrity. The FSC's statutory fit and proper requirements are used as measurement criteria.
2. **Independence and Conflicts of Interest** – Credit Rating Agencies must be independent and free from political or economic pressures and from conflicts of interest arising due to the credit rating agencies' ownership structure, business or financial activities, or the financial interests of the credit rating agencies'

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<sup>4</sup> Adopted from the International Organization of Securities Commission ("IOSCO") Statement of Principles Regarding the Activities of Credit Rating Agencies, September 25, 2003.

employees. Credit rating agencies must as far as possible, avoid activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of the credit rating operations.

- 2.1 Credit Rating Agencies must adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinion and analyses that Credit Rating Agencies make or the judgment and analyses of the individuals the Credit Rating Agencies employ who have an influence on rating decisions. Credit Rating Agencies must disclose such conflict avoidance and management measures.
  - 2.2 The credit rating a Credit Rating Agency assigns to an issuer must not be affected by the existence of or potential for a business relationship between the Credit Rating Agency (or its affiliates) and the issuer or any other party.
  - 2.3. Credit Rating Agencies and Credit Rating Agency staff must not engage in any securities or derivatives trading presenting inherent conflicts of interest with the Credit Rating Agencies' rating activities.
  - 2.4. Reporting lines for Credit Rating Agency staff and their compensation arrangements must be structured to eliminate or effectively manage actual and potential conflicts of interest. A Credit Rating Agency analyst must not be compensated or evaluated on the basis of the amount of revenue that a Credit Rating Agency derives from issuers that the analyst rates or with which the analyst regularly interacts.
  - 2.5. The determination of a credit rating must be influenced only by factors relevant to the credit assessment.
  - 2.6 Credit Rating Agencies must disclose the nature of the compensation arrangement that exists with an issuer that the Credit Rating Agency rates.
3. **Transparency and Timeliness of Ratings Disclosure** – Credit Rating Agencies must make disclosure and transparency an objective in their ratings activities.
- 3.1. Credit Rating Agencies must distribute in a timely manner their rating decisions regarding publicly issued fixed-income securities or issuers of publicly traded fixed-income securities.
  - 3.2. Credit Rating Agencies must disclose to the public, on a non-selective basis, any rating regarding publicly issued fixed income securities as well as any subsequent decisions to discontinue such a rating if the rating is based in whole or in part on material non-public information.

- 3.3. Credit Rating Agencies must publish sufficient information about their procedures and methodologies so that outside parties can understand how a rating was arrived at by the Credit Rating Agency. This information must include (but not be limited to) the meaning of each rating category and the definition of default and the time horizon the Credit Rating Agency used when making a rating decision.
- 3.4. Credit Rating Agencies must publish sufficient information about the historical default rates of Credit Rating Agency rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how ratings categories have changed.
- 3.5. Credit Rating Agencies must disclose if a rating is unsolicited.
4. **Confidential Information** – Credit Rating Agencies must maintain in confidence all non-public information communicated to them by any issuer, or its agents, under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.
  - 4.1. Credit Rating Agencies must adopt procedures and mechanisms to protect the non-public nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.
  - 4.2. Credit Rating Agencies must use non-public information only for purposes related to their rating activities or otherwise in accordance with their confidentiality agreements with the issuer.

### C. Disclosure Requirements

“Credit rating agencies issue opinions on the future creditworthiness of a particular company, security or obligations as of a given date. These opinions tend to be relied upon by investors, lenders, and others, and accordingly, Credit Rating Agencies can have an effect on securities markets in a variety of ways. Credit ratings can affect issuers’ access to capital, influence the structure of financial transactions, and determine the types of investments fiduciaries and others can make. ...Given the influence Credit Rating Agency opinion can have on securities markets, the activities of Credit Rating Agencies are of interest to investors, lenders, issuers and securities regulators alike.”<sup>5</sup>

Given the significance that credit ratings can have on the securities market, the FSC

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<sup>5</sup> Taken from IOSCO Statement of Principles regarding the activities of Credit Rating Agencies, September 2003

considers that the following should be considered as required disclosure:<sup>6</sup>

1. A clear statement of what the ratings issued by the agency mean (probability of default of the rated debt instrument)
2. A document detailing the limitations of the ratings process
3. A clear and comprehensive account of the ownership. This is to be circulated in the public domain, and updated whenever there are significant changes in the ownership
4. Names, qualifications and experience of Directors, Senior Management and Members of the Rating Committee.
5. The rating process and criteria for all categories of ratings and types of issuers
6. Policy on time to be taken to disseminate a rating which has been assigned / accepted
7. Policy on time to be taken to release rating rationale (summary rationales are to be released along with the rating), along with guidelines on what the rationale will contain
8. Default and transition statistics which are to be compiled regularly and can be made available to users for a fee
9. Policy on dependence on third parties
10. A clear document on the review and appeal process
11. Policy on unsolicited ratings
12. Policy on rating withdrawals
13. Policy on disclosure of unaccepted ratings
14. Policy on surveillance of current ratings
15. Policy on preserving confidentiality of privileged information (and exceptions for regulatory queries)
16. An explicit code of ethics to be signed and adopted by each member of the agency
17. Policy on the period of validity of ratings
18. Policy on working relationship with regulators

The FSC invites comments and suggestions from interested parties regarding the contents of this document. The deadline for submission is **February 28, 2005**. Please direct your comments to:

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<sup>6</sup> Adopted from the Best Practice Checklist of the Association of Credit Rating Agencies in Asia (ACRAA)