



FINANCIAL SERVICES COMMISSION

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Guidelines for the Regulatory Oversight of Credit Rating Agencies

BACKGROUND

The establishment of regionally based credit rating agencies is a significant development for the region's financial and capital markets. The Financial Services Commission ("FSC") expects that opinions issued by these agencies will have a growing influence on the markets as credit ratings signal the future creditworthiness of rated entities. Credit ratings can affect issuers' access to capital, influence the structure of financial transactions, and determine the types of investments that fiduciaries and others can make. Given the expected influence of credit ratings on the functioning of securities markets, the FSC has developed a regulatory framework for monitoring the operations of credit rating agencies within its jurisdiction so as to preserve the integrity of financial markets.

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")."¹ 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 recognized rating agency because those securities are considered to be more liquid and less volatile in price than securities that are not so highly rated.²

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 recognized rating agencies could be incorporated into these guidelines, thus

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

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

making the process dynamic and more reflective of the changing risk profiles of securities held.

THE REGULATORY MODEL

The FSC is adopting a regulatory model whereby credit rating agencies are subjected to a process of “recognition” and “de-recognition”. This process consists of the following components:

- A. An initial assessment based on several elements listed below, thus allowing the regulator to formally recognize 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 Agency³

The initial regulatory assessment of a new entrant credit rating agency will be based on an assessment of the following:

1. The organizational structure of the rating organization (composition of the board of directors, shareholder structure);
2. The rating organization’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 background, size and experience of the rating agency’s technical assistance provider, in instances where such services are utilized;
5. The rating organisation's independence from the issuers or issues that it rates;
6. The rating organisation's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and,
7. Whether the rating organization has internal procedures to prevent the misuse of non-public information and how those procedures are followed.

³ 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

In addition to the above, for new entrant credit rating agencies that have been operating in other national markets, the FSC will determine whether the rating agencies are ‘nationally recognized’ in their home market as an issuer of credible and reliable ratings by their regulators as well as the predominant users of securities ratings. In the case of new entrant rating agencies using a technical assistance provider, the FSC will also determine whether the technical assistance provider is nationally recognized in its home market.

B. Periodic Regulatory Review of Credit Rating Agencies

Once recognition has been granted, the periodic review of a credit rating agency will be guided by an evaluation of the operations of the rating agency in the following areas⁴ : Quality and Integrity of the Rating Process; Independence and Conflicts of Interest; Transparency and Timeliness of Ratings Disclosure; and the Treatment of Confidential Information. The principles to be adhered to in these areas will 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 and systematic. For Credit Rating Agencies with 10 or more years of operation, ratings must be subject to some form of validation based on historical experience.
 - 1.2. Credit Rating Agencies must continuously monitor all outstanding ratings on a best efforts basis, without regard to the level of cooperation from the rated entity. In the event that this results in an uneconomic surveillance burden on the rating agency, suitable notification should be made in public before suspending or withdrawing such ratings.;
 - 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

⁴ Adopted from the International Organization of Securities Commission (“IOSCO”) Statement of Principles Regarding the Activities of Credit Rating Agencies, September 25, 2003.

properly assess the entities they rate, seek out information they need in order to make an assessment, and analyze all the information relevant to their decision-making processes.

- 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' 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. It is recommended that these procedures and mechanisms incorporate the provisions of the International Organization of Securities Commissions ("IOSCO") Code of Conduct Fundamentals for Credit Rating Agencies.⁵
 - 2.2 While acknowledging the practice of rating agencies charging rated entities for credit ratings and other financial information services, the credit rating a Credit Rating Agency assigns to an issuer or issue 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 must maintain a Chinese wall separation between their ratings business and their non-ratings business when such non-ratings business becomes significant to the overall revenues of the company. As an initial benchmark, the FSC will regard non-ratings business revenue as "significant" if it accounts for 30% or more of the total revenues of a credit rating agency.
 - 2.4 In order to manage the inherent conflicts of interest presented by rating agency staff engaging in securities or derivatives trading, Credit Rating

⁵ The Technical Committee of the International Organization of Securities Commissions "Code of Conduct Fundamentals for Credit Rating Agencies" December 2004.

Agencies must articulate a detailed insider trading policy in writing, which is signed off by all its personnel. This policy should cover among other things, those securities which need prior written approval by immediate superiors, periodic disclosure of holdings, appropriate trading windows for each security, and the like. In addition to the insider trading policy, the rating agency must disclose, at the time that a rating is issued, any interest that it or its staff has in the issuer or issue being rated as well as any trading activity that took place during the rating process.

- 2.5. 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. In general, 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 or issues that the analyst rates or with which the analyst regularly interacts. For rating agencies with five or more years of operation, the business development and analytical functions must be clearly separated (an example of a lack of separation would be where a credit rating analyst doubles as the sales person making the sales pitch to companies). In the case of rating agencies with less than five years of experience, if business development and analytical functions overlap, then no part of the salary or compensation of a business development person who also has analytical responsibilities should be based on the ratings assigned or the amount of direct business sourced.
 - 2.6 The determination of a credit rating must be influenced only by factors relevant to the credit assessment.
 - 2.7 Credit Rating Agencies must disclose its general fee guidelines and policies such as whether or not the agency operates on an “issuer pays” model, the measures taken to manage conflicts of interest and the fee structure.
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 general 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.
- 3.4. Credit Rating Agencies with 10 or more years of operation 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. **Treatment of 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

The FSC will require the following disclosures:⁶

1. A clear statement of what the ratings issued by the agency mean (the “probability of default” or the “expected loss” 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 and

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

- issues;
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 (this is mandatory for rating agencies with 10 or more years of operation);
 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.

COMPLIANCE PROCEDURES

Parties interested in being recognized are invited to discuss with the FSC how they may do so. A list of recognized Credit Rating Agencies will be maintained by the FSC and made available for public use. Recognition or de-recognition of a Credit Rating Agency in accordance with these guidelines, does not constitute an endorsement, or lack thereof, by the FSC of any information, opinion or ratings prepared and published by the Credit Rating Agency.