

U.S. Structured Finance Newsletter

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NEW EUROPEAN REGULATION ON CREDIT RATING AGENCIES

DBRS welcomes the new European regulatory framework for credit rating agencies (CRAs; the Regulation) that was approved by the European Parliament on April 23, 2009. The Regulation has been many months in the making, beginning with the original draft introduced by the European Commission in November 2008. The Committee of European Securities Regulators (CESR), which has been tasked as the omnibus regulator, must now draft the detailed accompanying rules to put the new Regulation into action. The Regulation formalizes a regime for registration, regulation and supervision of CRAs in the European Union (EU), with the aim that ratings will be qualitatively better than under current standards. However, it is important to point out that global CRAs such as DBRS¹ have been subject to regulation, increased oversight and high standards for several years and have also initiated many adjustments to their business practices.²

The *Code of Conduct Fundamentals for Credit Rating Agencies* (the IOSCO Code), developed by the International Organization of Securities Commissions (IOSCO), serves as a starting point for oversight in the new Regulation. The IOSCO Code was first published in December 2004 and was updated in May 2008, particularly in response to the subprime mortgage crisis. The G20 recently reinforced the IOSCO Code as a standard benchmark for jurisdictions around the world because the framework is designed to improve investor protection and promote the fairness, efficiency and transparency of the securities markets while reducing systematic risk. CRAs that have adopted the IOSCO Code are subject to annual assessments by IOSCO and CESR regarding compliance.

In the United States, CRAs that are registered with the Securities and Exchange Commission (SEC) as nationally recognized statistical rating organizations (NRSROs) have been subject to regulation and supervision since June 2007 under the *Credit Rating Agency Reform Act of 2006* and, prior to that, were subject to a compliance review under the SEC *Investment Advisers Act of 1940*. Although the SEC's NRSRO rules are not identical to those of the IOSCO Code, they address the same basic principles and do so in a way that allows NRSROs to comply comfortably with both. The SEC has also recently fortified its rules in response to the subprime mortgage crisis. In addition, those CRAs that have External Credit Assessment Institution (ECAI) recognition under Basel II capital requirements guidelines are monitored and undergo annual reviews.

DBRS agrees that, in conjunction with market scrutiny, formal regulatory oversight of CRAs in the EU will help increase CRA transparency and ensure accountability regarding the integrity and independence of their operations. By establishing formal regulation, regulators are saying that CRAs continue to play an important capital markets and regulatory function and that credit ratings continue to provide an independent point of reference for investors and other market participants.

Improvements from the original version of the Regulation include the following: limitations have been put on the scope of ratings used for regulatory purposes; there will be a broad 12- to 18-month compliance window after the Regulation comes into effect, which is not expected before summer 2009; and there will be a two-pronged approach to recognize ratings provided by non-EU CRAs, by way of either endorsement by an affiliated EU-based CRA or certification by CESR that the non-EU CRA is subject to an "equivalent" regulatory regime. The notable areas of the Regulation that differ from the IOSCO Code include the following: the requirement that structured finance ratings have some form of additional symbol to distinguish them from other ratings; an individual analyst rotation mechanism to avoid conflicts of interest; a requirement for an independent advisory board that includes structured finance expertise where such ratings are issued; and the publication of a transparency report on ownership, the outcome of the annual internal review of compliance and a description of the management and analyst rotation policy.

It will take some time for CESR to draft the rules and work out areas such as "equivalent" regulation, but it is committed to monitor the effectiveness of the Regulation. In doing so, it is DBRS's hope that CESR will come to see that globally consistent regulatory regimes are critical for well-functioning markets. DBRS plans to meet the new Regulation within the timelines as required and looks forward to discussing the rules and their practical application with EU securities regulators.

For questions or comments, please contact Mary Keogh at mkeogh@dbrs.com.

1. DBRS has adopted and complies with the IOSCO Code, is an NRSRO and has achieved ECAI in the United States, Canada, Switzerland and the European Union.
2. See [DBRS Initiatives to Enhance the Quality and Transparency of Its Ratings Process](#), a commentary published on March 5, 2009, on www.dbrs.com.