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To: FINMA

Via e-mail to: [ratingagencies@finma.ch](mailto:ratingagencies@finma.ch)

**Re: DBRS' response to FINMA Circular 2008/26 on Credit Rating Agencies – Draft Modification (“FINMA’s Draft Modification”)**

DBRS<sup>1</sup> appreciates the opportunity to provide its comments on FINMA’s Draft Modification.

DBRS understands that the proposed modifications to Circular 2008/26 on Credit Rating Agencies (CRAs) are intended to extend the requirements for CRAs to all entities supervised by FINMA and to create more standardized conditions for CRA recognition taking into account international developments. Changes that have been incorporated into this circular among others include the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code)<sup>2</sup> and relevant areas from the Basel Committee on Banking Supervision “Basel III”, December 2010.

The current circular “Recognition of rating agencies for the assessment of capital adequacy requirement” was originally put in force in January 2007 by the Swiss Federal Banking Commission (SFBC), one of FINMA’s predecessor authorities. The circular defined recognition requirements for CRAs whose ratings are used by banks and securities dealers to calculate required equity capital. Based on this circular, DBRS was recognized as an external credit rating agency<sup>3</sup> by SFBC in March 2007. When FINMA was set up in early 2009, it incorporated this circular, renaming it FINMA-Circ. 08/26, and assumed existing CRAs including DBRS’ ECAI recognitions.

The Draft Modification proposes to extend application to ratings used by insurance companies and collective investment schemes. FINMA has determined to continue to use the system already established for CRA recognition. This means that CRAs recognized by FINMA will not be subject to its supervision under Article 3 of the Financial Market Supervisory Act. However, for CRAs domiciled outside Switzerland<sup>4</sup>, FINMA will consider monitoring by foreign supervisory authorities.

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<sup>1</sup> DBRS operates its rating business through DBRS Limited, DBRS, Inc. and DBRS Ratings Limited.

<sup>2</sup> The IOSCO Code was updated in May 2008.

<sup>3</sup> External Credit Assessment Institution (ECAI).

<sup>4</sup> There are currently no CRAs with a head office based in Switzerland.



## DBRS comments

### *V. Recognition of rating agencies*

#### *B. Requirements*

The Draft Modification states that recognition of rating agencies is based on the IOSCO Code which must be publicly available, observed at all times and any deviations must be disclosed with the reasons for them. FINMA has also added other requirements which are set out under six areas: Objectivity, Independence, Access and transparency, Disclosure, Resources and Credibility.

DBRS notes that in some cases, the additional proposed requirements differ substantially from the IOSCO Code and other international regulatory rules. These differences include proposed section 27 under Objectivity, section 32 under Independence and section 46 regarding Resources.

As a global CRA whose ratings are used internationally, DBRS believes that regulation should be internationally harmonized to the extent possible based on a common set of principles that promote a high degree of transparency and disclosure, analytical independence, and integrity and objectivity in the ratings process. Departures from well-established standards or global precedent such as the IOSCO Code or the EU CRA Regulation could create a destabilizing impact on the consistency of ratings and the capital markets, and imposes increased compliance burden and cost for all CRAs with little additional benefit.

The IOSCO Code is a common set of global measures that without modification is one aspect of international regulatory frameworks. DBRS complies with the IOSCO Code, as reflected in its publicly available Business Code of Conduct. In addition to the Business Code, DBRS also has established policies and practices to meet specific jurisdictional requirements including the U.S.<sup>5</sup> and Europe<sup>6</sup>. Canada will be implementing a new regulatory regime in 2011.

#### *a) Objectivity*

Under requirements for objectivity, before qualifying for recognition, FINMA requires *“the rating method for every individual market segment, including rigorous back testing, must have been in use and been proven effective for at least three years. In justified exceptional cases, FINMA may reduce the period of proven application of the rating method to not less than one year.”*

This requirement differs substantively from IOSCO Code provision 1.2 wherein “A CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.” It also differs, for example, from the EU CRA Regulation. Article 8.3 states that validation should include back-testing but does not mandate a specific period nor approach.

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<sup>5</sup> U.S. Securities and Exchange Commission rules for Nationally Recognized Statistical Rating Organizations (NRSRO).

<sup>6</sup> EU Credit Rating Regulation 1060/2009 (EU CRA Regulation).



A requirement for a specific period of back-testing would impact the rating of new products and development of new methodologies. It would also preclude CRAs who might have a relatively small historical ratings universe who would otherwise issue high quality ratings. This proposed requirement could have a negative impact on the markets and on CRA competition. DBRS suggests that this particular requirement for objectivity does not need to depart from the IOSCO Code language.

#### *b) Independence*

FINMA requires that the CRA “ *may not be associated with public-sector entities, companies or issuers of products in the structured finance market segment for which it produces ratings (ratings of issuer or issues) or with institutions subject to supervision by FINMA which use its ratings. An inadmissible association is deemed to exist not only if a participating interest exists, but also if significant influence can be exercised over the rating agency or individual ratings or there is the appearance of such influence* “

DBRS agrees that analytical independence in sectors that a CRA rates must be maintained at all times. However, the above requirement singles out public sector entities and the structured finance (SF) market. DBRS would suggest that such specificity is unnecessary. CRAs currently follow a broader precedent for conflicts of interest. It is also unclear what is meant by the term “may not be associated”. DBRS would suggest that the IOSCO Code provisions regarding Analyst and Employee Independence<sup>7</sup> are sufficiently robust noting that international rules are similar in this area.

FINMA requires that “*The rating agency must ensure through organisational means that there is an adequate functional separation between operational rating activities and advisory activities.*” FINMA’s proposed requirement differs in a couple of ways from global standards. The term “advisory services” is not discussed in the IOSCO Code<sup>8</sup>. It focuses on the conflicts of interest posed by consulting services by requiring CRAs to separate, operationally and legally, their credit rating activities from this business. And the EU CRA Regulation<sup>9</sup> prohibits the provision of consultancy or advisory services to rated entities or related third parties. The IOSCO Code and the EU CRA Regulation do discuss ancillary services, and permit a CRA to provide ancillary services as long as they do not present conflicts of interest. DBRS would suggest that FINMA adopt the IOSCO provision language given the basis of FINMA’s recognition is the IOSCO Code.

#### *c) Access and transparency*

FINMA requires the CRA to disclose “*whether or not the issuer was involved in the rating process.*”

<sup>7</sup> Refer to IOSCO Code section 1. C. CRA Analyst and Employee Independence, Provisions 2.11- 2.17 as well as Provision 1.14-1 regarding the prohibition on analysts making proposals or recommendations regarding the design of SF products that a CRA rates.

<sup>8</sup> Refer to IOSCO Code section 2. CRA Independence and Avoidance of Conflicts of Interest, Provision 2.5.

<sup>9</sup> Refer to EU CRA Regulation, Annex 1, Section B, Operational Requirements, Point 4.



DBRS considers ratings where there is no issuer participation to be unsolicited ratings and identifies these ratings as such in its ratings press releases. DBRS will only assign unsolicited ratings when sufficient public information is available to support the analysis and monitor the rating on an ongoing basis. Unsolicited ratings are subject to DBRS' established ratings policies, procedures and methodologies and are covered by its conflicts of interest and unfair, coercive or abusive business practices policies and procedures.

#### *e) Resources*

*FINMA proposes that "The rating agency must have sufficient resources (finances, personnel, infrastructure, etc.) to enable it to carry out ratings of a high quality. Where ratings are used in agreements, the resources should have close contact with the executive bodies of the borrower being rated/issuer of the credit instruments being rated"*

The second sentence in this proposed provision is somewhat unclear. DBRS suggests that FINMA clarify it. As scripted, DBRS would suggest that requiring close contact with issuers runs contrary to the objectivity requirements for analytical independence from issuers that a CRA rates. It is unclear as to the purpose of this aspect of the requirement.

#### *C. Recognition Procedure*

The Draft Modification indicates that in evaluating the application, FINMA takes into account whether the CRA is recognized by foreign supervisory authorities. CRAs domiciled abroad may apply for a simplified recognition process or waive proof of compliance if they are subject to adequate local supervision in the following jurisdictions: Australia, EU countries, Japan and U.S.

DBRS suggests that FINMA add Canada to this list. As previously indicated, Canada has proposed a regulatory framework<sup>10</sup> planned for implementation in 2011.

#### *VI. Compliance with recognition requirements*

The Draft Modification states *"For rating agencies that are subject to foreign supervision, FINMA may take the findings of the foreign supervisory authorities or the measures they impose on the rating agencies into consideration when evaluating a rating agency's fulfillment of the requirements for recognition.*

*If shortcomings are found in a rating agency's fulfillment of the requirements for recognition, FINMA may impose measures appropriate to resolving the shortcoming or may temporarily or permanently revoke recognition. If FINMA revokes a rating agency's recognition, the ratings of that agency can no longer be used for supervisory purposes by institutions subject to supervision. The rating agency bears the costs of the procedures that resulted in the revocation of its recognition in accordance with the FINMA-GebV."*

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<sup>10</sup> National Instrument 25-101 Designated Rating Organizations, Related Policies and Consequential Amendments



DBRS appreciates FINMA's pragmatic approach to recognition. DBRS would not disagree that FINMA should take into account the findings of foreign supervisory authorities or the measures they impose into consideration when evaluating a CRA's fulfillment of the recognition requirements.

However, DBRS suggests that FINMA also needs to consider the CRA's management response and action plan to resolving the findings of foreign regulators before it determines what, if any, additional measures it might impose. It should also be noted that other regulators typically take a stepped approach to breaches of compliance with requirements that are proportional to the infraction including withdrawal of the rating. Temporarily or permanently revoking the recognition of a CRA would have a significant market impact and unplanned regulatory capital consequences for institutions, especially if the CRA is the only rater.

DBRS would be pleased to further discuss any of the matters raised herein and/or provide additional information. Please do not hesitate to contact me.

Very truly yours,

A handwritten signature in black ink, appearing to read "Mary Keogh". The signature is fluid and cursive, with a large initial "M" and "K".

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