

Review of credit rating agencies and research houses

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**A joint report by the Treasury
and the Australian Securities
and Investments Commission**

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Note: This report is referenced as REP 143 on ASIC's website.

A The Review

Key points

This joint Treasury/ASIC Report reviews the regulation of credit rating agencies (CRAs) and financial product research houses (research houses) in Australia.

Currently:

- CRAs have ASIC class order relief from Australian Financial Services licensing provisions on the basis that they comply with the 2004 International Organization of Securities Commission (IOSCO) *Code of Conduct Fundamentals for CRAs* (IOSCO Code).
- research houses are required to be licensed.

Background to paper

- 1 This is a joint Report prepared by Treasury and the Australian Securities and Investments Commission (ASIC) into the regulation of credit rating agencies (CRAs) and financial product research houses (research houses). This Report is a description of the current regulatory framework, regulatory issues, international developments and market context.
- 2 This review follows the 22 May 2008 announcement by the Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry, in which he asked Treasury and ASIC to review the regulation of CRAs and research houses and report to the Government within six months.
- 3 In preparing this Report, Treasury and ASIC have had preliminary discussions with a range of CRAs and research houses, industry and consumer groups as well as the Australian Prudential Regulation Authority (APRA).

Credit rating agencies

- 4 Section B of this Report looks at the contemporary background to this regulatory review of CRAs in Australia.
- 5 Credit ratings play an important role in financial markets. These ratings synthesise the vast array of information available about an issuer or borrower, its market and its economic environment. This gives investors and lenders a better understanding of the risks associated with borrowing or lending from a particular entity or investing in a particular debt-like financial product.

- 6 Without relief, CRAs operating in Australia would have to hold an Australian Financial Services Licence (AFS licence) under the Corporations Act. Currently the following CRAs have AFS licensing relief under Class Order (CO 05/1230) *Credit rating agencies* on the basis that they comply with the 2004 IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO Code):
- (a) Moody's Investor Service Pty Limited (Moody's);
 - (b) Standard & Poor's (Australia) Pty Limited (Standard & Poor's); and
 - (c) Fitch Australia Pty Limited (Fitch).

When this relief was announced, ASIC stated that it would revisit this approach if there were international developments.

- 7 It is now widely acknowledged internationally that flaws in CRAs' assessments of US 'sub-prime' residential mortgage-backed securities (RMBSs) and collateralised debt obligations (CDOs) (collectively, 'structured finance products') were among the principal underlying causes of recent market turmoil.
- 8 The role played by CRAs in recent global market turmoil has prompted a number of international reviews, including those of IOSCO, the Financial Stability Forum (FSF), the Committee of European Securities Regulators (CESR), the European Commission and the US Securities and Exchange Commission (SEC).
- 9 Treasury and ASIC are monitoring these international developments, including the idea of a global oversight body for CRAs and the prospect of enhanced international regulatory cooperation in monitoring CRA compliance with the revised IOSCO Code.
- 10 Section C of this Report considers how Australian law and regulation might address the key regulatory issues concerning CRAs that have emerged from these international reviews. These include:
- (a) appropriate level of external oversight;
 - (b) quality of the ratings process;
 - (c) monitoring and updating of ratings;
 - (d) conflicts of interest;
 - (e) disclosure issues;
 - (f) adequacy of organisational resources; and
 - (g) over-reliance on credit ratings by investors.

Research houses

- 11 Section D of this Report outlines the current regulation of research houses in Australia. For the purposes of this review, these research houses include those firms (excluding credit ratings and ‘in-house’ investment bank securities analysts) that provide ratings, recommendations or opinions on financial products, such as managed investment schemes, superannuation, insurance and debt products. These ratings, recommendations or opinions are referred to in this paper as ‘product ratings’.
- 12 Research houses play a useful role in the Australian financial system by providing third party analysis of financial products. For example, financial advisers use product ratings when selecting financial products for their approved product lists. However recent corporate collapses involving products and funds that had received investment-grade ratings (e.g. Westpoint, Fincorp and Basis Capital) have raised some issues that may require further guidance. Other options discussed for addressing these issues include targeted AFS licence conditions or regulations.
- 13 Research houses must hold an AFS licence because they provide general financial product advice. Section C examines how AFS licensing provisions apply to research houses. It discusses:
 - (a) AFS licensing requirements for research houses and their use of disclaimers;
 - (b) independence and conflicts of interest;
 - (c) over-reliance on product ratings by advisers;
 - (d) disclosure issues;
 - (e) the quality of the ratings process; and
 - (f) the monitoring and updating of ratings.

B Credit rating agencies—background and international developments

Key points

There have been several international reviews and regulatory initiatives in response to the role of CRAs in current global market turmoil, including revisions to the 2004 IOSCO Code, US SEC draft rule proposals and a European Commission draft directive. It also notes the work of the Financial Stability Forum (FSF).

Treasury and ASIC will continue to monitor regulatory developments in the US and Europe closely. ASIC supports the work of the IOSCO CRA Task Force in exploring options for regulators to verify compliance with the revised IOSCO Code.

Role of credit rating agencies

- 14 A CRA is an organisation that issues credit ratings. A credit rating (sometimes also called a debt rating) is an opinion about whether an issuer of a credit commitment, debt or debt-like security is likely to make timely repayment of its financial obligations generally or a particular financial obligation.
- 15 A credit rating:
- (a) does not typically include a recommendation to 'buy', 'sell' or 'hold' a financial obligation; and
 - (b) is not an opinion about an obligation's value.
- 16 CRAs play an important role in modern financial systems. Their ratings synthesise the vast array of information available about an issuer or borrower, its market and its economic environment, in order to give investors and lenders a better understanding of associated credit risks. CRAs have also been described as playing a 'gatekeeper' role in the market.
- 17 In practice, CRAs provide a range of advice to the entities in the financial system, for example:
- (a) **Issuers and corporate borrowers** rely on (and, in many cases, pay for) opinions issued by CRAs to help them raise capital;
 - (b) **Investors and lenders** typically insist on being compensated for uncertainty and, when taking on debt, issuers pay for this uncertainty through higher interest rates. CRA opinions that help reduce uncertainty for investors also help reduce the cost of capital for issuers. Lenders and

investors in fixed income securities, by contrast, use credit ratings in assessing the likely risks they face when lending money to or investing in the securities of a particular issuer;

- (c) **Institutional investors and fiduciary investors** use credit ratings to help them allocate investments in a diversified risk portfolio; and
- (d) **Government regulators** may also use credit ratings for a variety of purposes, including setting capital charges for financial institutions according to the credit risks of the institutions' various investments.

- 18 CRAs reduce complexity in the financial system and reduce transaction costs associated with financial dealings. Entities rely on the ratings provided by CRAs because of the reputation and credibility of such organisations. Credit ratings are, in effect, a 'signal' that is used with other due diligence that might be undertaken as part of a transaction.

Australian market context

- 19 The Australian CRA market is almost entirely comprised of three major, global CRAs: Moody's, Standard & Poor's and Fitch. Foreign and domestic wholesale investors are the main users of credit ratings of Australian originated products. In Australia there is only limited retail use of credit ratings (e.g. in debenture issues, bank prospectuses and some exchange-listed structured finance products).
- 20 The most recent comparable financial information on all three of these participants shows that these agencies' aggregate sales revenue for 2006–2007 was approximately \$87 million. Standard & Poor's accounts for an estimated two-thirds of this market. The agencies do not provide a breakdown of their Australian revenue by line of business. Two of them, Standard & Poor's and Moody's, currently hold an AFS licence for their other research businesses.
- 21 These CRAs derive revenue from both subscribers and issuers. A 'subscriber revenue model' involves CRAs earning revenue by providing access to a credit rating to anyone paying a fee. Under an 'issuer revenue model', the entity seeking a rating pays a fee to be rated: the rating is sought from those raising debt or issuing a structured finance product. In some instances, a CRA may also offer an unsolicited rating, in response to a demand from its subscribing customers.

Competition

- 22 As noted above, three large players in the Australian market dominate the provision of ratings advice. These firms are global in nature and have long histories of providing credit ratings.

- 23 As large incumbent players with substantial reputations in this specialised field, these CRAs benefit from practical rather than regulatory barriers to entry that entrench their market position. The relative size of the Australian financial system and the business opportunities for CRAs in this market further reinforces their position.
- 24 On this analysis, the main barriers to increased competition in the Australian system are the size, scale and reputation of the established market participants. Overall, the barriers to increased competition appear to be medium to high.
- 25 In the global CRA market, concerns have been raised that a lack of competition may permit CRAs to make less effort and engage in less research than would be the case in a more competitive environment. It has also been suggested that CRAs have been too reactive, responding to negative information that has been publicly released, rather than anticipating market developments. It is thought that more active competition among CRAs would result in a swifter response to the signs of credit deterioration.

Role of CRAs in recent global market turmoil

- 26 Beginning in 2007, delinquency and foreclosure rates for sub-prime mortgage loans in the United States have dramatically increased, creating turmoil for markets in structured finance products linked to these residential mortgages. The repricing of risk in these structured finance products has undercut investors' confidence in the credit ratings of these and other structured finance products.
- 27 In the United States, the market for sub-prime products grew substantially over the past 12 years. For instance, the number of sub-prime mortgages increased from \$421 billion to \$640 billion between 2002 and 2006. Put another way, sub-prime mortgage products grew from 14% of all loans to 22% of all loans over the same period. Over the last five years, structured finance product issuances have also proliferated, driven by the search for attractive returns and the incentive for banks to take these loans off their balance sheets.
- 28 The complexity of structured finance products has increased investor reliance on credit ratings, as the analysis of the underlying assets and the correlation risk is challenging. Investors may lack expertise, or be tempted to avoid the costs of doing their own analysis. Other factors contributing to the emphasis placed on credit ratings of structured finance products have included the absence of an active secondary market for these products, the lack of sufficient historical performance data, and the lack of a universally agreed valuation method.

- 29 In response to this increased demand, CRAs have applied and developed methodologies to rate structured financial products, which also have grown to be a significant source of revenue and income. By 2007, ratings of structured finance products represented around 40 to 50% of global CRA revenue.
- 30 As the sub-prime events unfolded, the CRAs engaged in rating revisions and multi-notch downgrades. This has raised concerns about the accuracy of their ratings and the integrity of their ratings process.

International regulatory responses

- 31 There have been several international regulatory reports and initiatives in response to recent global market turmoil. As outlined below, there is substantial agreement on many of the key regulatory issues identified.

International Organization of Securities Commissions

- 32 Following a request from the FSF in April 2007, the IOSCO Technical Committee asked its CRA Task Force to analyse the role of CRAs in structured finance markets and consider whether or not the IOSCO Code required revision.
- 33 On 28 May 2008, IOSCO published the final report of the CRA Task Force, including a number of revisions to the IOSCO Code.
- 34 The 2008 revisions affect the following sections of the Code:
- (a) **Section 1: Quality and Integrity of the Rating Process:** amendments designed to enhance the integrity of the information and methodologies used in the rating process.
 - (b) **Section 2: CRA Independence and Avoidance of Conflicts of Interest:** amendments focusing on potential areas of conflict such as ‘ratings shopping’, issuer/analyst interactions and analyst remuneration policies and practices.
 - (c) **Section 3: CRA Responsibilities to the Investing Public and Issuers:** amendments specifying the types of data used to rate products that should be published for the benefit and information of investors. This includes differentiating between ratings of structured financial products from other products, ‘preferably through different rating symbols’.
 - (d) **Section 4: Disclosure of the Code of Conduct and Communications with Market Participants:** A new requirement for a CRA to prominently and publicly publish links to its own code of conduct, a description of the methodologies it uses, and information about its historic performance data.

The G7 and the Financial Stability Forum

- 35 In October 2007, the G7 Finance Ministers and Central Bank Governors asked the FSF to analyse and report on the causes and weaknesses responsible for recent global market turbulence.
- 36 On 12 April 2008, the FSF presented its report to the G7 Finance Ministers and Central Bank Governors. Section IV of the report deals with CRAs. The FSF stated that poor assessments by CRAs contributed to the build-up and rapid unfolding of global financial system instability. The FSF also noted the actions undertaken by CRAs since the sub-prime crisis to improve their internal governance and operational practices, but said that more was needed.
- 37 The FSF made recommendations regarding CRAs in four areas:
- (a) improving the quality of the rating process;
 - (b) differentiating structured and traditional debt products;
 - (c) enhancing the quality of underlying data for ratings; and
 - (d) reducing reliance on ratings by investors and regulators.
- 38 In October 2008, the FSF released a report on the implementation of its April recommendations to date and next steps. The FSF identified a greater role for industry in improving due diligence arrangements and called for better transparency of information by originators of structured finance products. It also flagged efforts to increase regulatory coordination in overseeing CRAs.

European Union

- 39 In late 2007 the European Commission sought advice from both CESR and the European Securities Markets Experts group (ESME) on the role of CRAs in structured finance and associated regulatory issues.
- 40 While ESME's June 2008 report recommended a more robust self-regulatory model based on further improvements to the IOSCO Code, CESR proposed the immediate formation of an international CRA standard-setting and monitoring body:
- to develop and monitor compliance with international standards in line with the steps taken by IOSCO, using full public transparency and acting in a 'name and shame' capacity to enforce compliance with these standards via market discipline.

41 CESR's report also recommended that, should the formation of a global body not be feasible in the short term, a similar body be established at an EU level.

42 On 8 July 2008 the Economic and Financial Affairs Council of the European Union (Ecofin), the institution of EU member states' economic and finance ministers, endorsed in principle CESR's recommendation that CRAs should be subject to an EU registration system and more stringent implementation of international standards.

43 The European Commission has moved quickly in response to Ecofin by issuing on 31 July 2008 a draft directive on EU registration.

United States

44 In its March policy statement the President's Working Group, a cross-agency forum chaired by the Secretary of the Treasury, found that flaws in CRAs' assessments of structured finance products were one of the 'principal underlying causes' of recent market turmoil. The working group called for reform of CRAs' processes for rating structured credit products.

45 On 11 June 2008, the SEC proposed a series of draft rules for CRAs in light of sub-prime issues. The draft rules address similar CRA issues to other international reviews, including conflicts of interest, disclosure, transparency, and investor protection. In contrast to other reviews, a stronger focus is given to differentiating between ratings given to structured products and bonds. In fact, one of the three sets of draft rules is devoted to this issue.

46 On 8 July 2008, the SEC released the findings from its 10-month examinations of three major CRAs (Fitch Ratings Ltd., Moody's Investor Services Inc. and Standard & Poor's Ratings Services). The examinations found significant weaknesses in CRAs' practices and disclosure to investors. These included issues relating to:

- (a) conflicts of interest;
- (b) dealing with increased volume of RMBSs and CDOs;
- (c) transparency of policies and procedures; and
- (d) internal audit processes.

The report also concluded that CRAs had already begun to address these problems by implementing reforms based on international concerns.

Global industry responses

47 In addition to governmental and international organisation responses to CRAs, industry has also taken some initiatives. Internationally, the major

global CRAs have been active in reviewing their internal practices and adopting new initiatives in light of global market events.

- 48 On the issue of additional external oversight via formal regulation, a joint response by the major global CRAs to CESR's February Consultation Paper noted:

[The Participating CRAs] are subject to direct supervisory oversight in certain jurisdictions including the United States... We believe that the creation of a parallel, regulatory regime in Europe could substantially increase the regulatory burden without generating sufficient, incremental benefits beyond those that could be achieved through more extensive and intensive collaboration between CESR and the SEC.

- 49 This response also suggested that, in Europe, market disciplinary forces have proven effective in persuading them to implement the existing IOSCO Code and amend their own codes where market participants or regulators have raised concerns.

C Regulation of credit rating agencies in Australia

Key points

CRAs have ASIC class order relief from Australian Financial Services licensing provisions on the basis that they comply with the 2004 International Organisation of Securities Commission (IOSCO) *Code of Conduct Fundamentals for CRAs* (IOSCO Code).

Current regulatory position

- 50 Without relief, CRAs that carry on a business of providing credit ratings in Australia must hold an AFS licence. A person carrying on a business of providing financial product advice in Australia attracts the AFS licensing provisions. Credit ratings are financial product advice under s766B(1).

Note 1: Section 766B(1) defines 'financial product advice' as 'a recommendation or statement of opinion, or a report of either of those things, that:

- (i) is intended to influence a person or persons in making a decision in relation to a financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
- (ii) could reasonably be regarded as being intended to have such an influence.'

Note 2: Credit ratings are general advice: s766B(4).

- 51 Following public consultation in 2005, ASIC gave CRAs relief from holding an AFS licence under Class Order CO 05/1230.

Note: see Consultation Paper 65 *Licensing: Credit rating agencies* (CP 65).

- 52 ASIC granted this relief on the condition that CRAs comply with the IOSCO Code. This means a CRA must:

- (a) disclose to the public its code of conduct (i.e. compliance systems and internal policies) and describe how it fully implements:
 - (i) the IOSCO *Principles Regarding the Activities of Credit Rating Agencies*; and
 - (ii) the IOSCO Code; or
- (b) if its code deviates, explain how it nevertheless meets the objectives of the IOSCO Code.

- 53 ASIC's reasons for this relief were that:
- (a) the financial services undertaken by CRAs are limited in nature;
 - (b) there are well-accepted international standards contained in the IOSCO Code;
 - (c) CRAs are global businesses, so global standards should apply; and
 - (d) CRAs were not licensed in other major jurisdictions.
- 54 The class order applies only to the obligation to hold an AFS licence—it does not relieve CRAs from other general provisions contained in the financial services laws. For example, the prohibition on misleading or deceptive conduct in relation to financial services (s12DA of the ASIC Act) currently applies to CRAs.

Key regulatory issues

- 55 As outlined in Section B, the role of CRAs in recent market turmoil has prompted a host of international reviews that have identified, and suggested, various responses to a range of issues. Table 1 summarises the key regulatory issues that have emerged from these international reviews.
- 56 The CRA industry has expressed concern about potentially inconsistent national regulatory responses to these issues.

Table 1: Summary of regulatory issues

Appropriate level of external oversight	What regulatory approach in Australia would best integrate with international mechanisms?
Quality of ratings process	Do CRAs critically assess the quality of information that they use to support a rating? Are their models, methodologies and assumptions up-to-date? Can the market effectively compare the historical performance of credit ratings?
Monitoring and updating of ratings	Are CRAs' existing processes for monitoring, regularly reviewing and updating ratings sufficient? Should particular requirements be imposed on CRAs for when and how they review ratings?
Conflicts of interest	Do CRAs' existing policies on conflicts of interest adequately address: <ul style="list-style-type: none"> • disclosure of significant revenue streams; • discouraging issuers from 'ratings shopping' ; • prohibiting analysts from advising on the design of structured finance products; • maintaining and reviewing rating analyst independence; and • separating the ratings business from any ancillary services provided by the CRA?
Disclosure issues	Do CRAs provide adequate information about individual ratings? Are additional disclosure requirements, such as different rating symbols for structured finance products or standardised risk, sensitivity and volatility assessments, necessary?
Adequacy of organisational resources	Do CRAs maintain adequate organisational resources to handle the volume and complexity of their business?
Over-reliance on credit ratings by investors	What can be done to prevent over-reliance on credit ratings by investors?

Key issues and the Australian financial services licensing regime

57 Australia's single licensing regime for financial service providers is a flexible regulatory framework that provides for principle-based oversight while being responsive to the particular circumstances of varied market participants.

Quality of the ratings process

- 58 A key issue for credit ratings of structured products is whether CRAs made a critical assessment of the quality and adequacy of the information underpinning their ratings provided by issuers. The FSF Recommendations said that CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers: Recommendation IV.6.
- 59 Under the revised IOSCO Code, CRAs must adopt reasonable measures so that the information they use in assigning a rating is of sufficient quality to support a credible rating: IOSCO Code paragraph 1.7.
- 60 Reasonable measures would involve a CRA critically evaluating the information provided to it and noting any grounds held for questioning the truth, accuracy and completeness of the information: consider here ASIC's expectations in the context of expert reports that they should rely on and set out their 'reasonable grounds' in forming an opinion: see Section D of ASIC Regulatory Guide 111 *Content of Experts Reports* (RG 111).
- 61 CRAs should consistently apply rating methodologies that are rigorous and systematic. CRAs should review their methodologies and models and assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially: revised IOSCO Code Part 1A.
- 62 The AFS licensing regime does not expressly impose a 'reasonable measures' requirement on licensees providing general financial product advice. However, licensees have general obligations to:
- (a) do all things necessary to ensure that their financial services (including advice) are provided efficiently, honestly and fairly: s912A(1)(a);
 - (b) take steps to ensure that they comply with the financial services laws: s912A(1)(c) & (ca); and
 - (c) maintain the competence to provide those financial services: s912A(e).
- 63 Implicit in these obligations is a requirement that general financial product advice (such as credit ratings) should be prepared by skilled and experienced representatives, be based on reasonable grounds and not be misleading. These principles are consistent with the existing obligation on CRAs at general law to ensure that they act with due care, diligence and competence when preparing their ratings.
- 64 Further, CRAs who fail to adopt 'reasonable measures' to ensure the quality of their ratings process may be subject to sanctions for engaging in misleading or deceptive conduct, or making false or misleading statements, in relation to financial services and products (see ss1014E and 1041H, Corporations Act;

ss12DA-12DB, ASIC Act). The threat of sanctions for such misconduct already applies to CRAs, as the current class order relief only relates to the obligation to hold an AFS licence.

Conflicts of interest

- 65 International standards and recent reports identify CRA conflicts of interest as an issue: e.g., ‘many observers cite the conflicts of interest inherent in the credit rating industry as a source of concern’—IOSCO Technical Committee Final Report *The Role of Credit Rating Agencies in Structured Finance Markets* (May 2008).
- 66 If CRAs were licensed under the AFS licensing regime, it would be required to have adequate arrangements for the management of conflicts of interest that may arise in relation to the provision of credit ratings: s912A(1)(aa). A CRA would be required to have in place arrangements (i.e. internal measures, processes and procedures) to avoid, control and disclose conflicts: see Regulatory Guide 181 *Licensing: managing conflicts of interest* (RG 181). A good example is the requirement to have arrangements for rigorous approval of a credit rating (e.g. a review committee) before release: see RG 79.2.13. It would be required to document these policies and procedures; implement them; and monitor them and keep records of this.
- 67 RG 181 sets out ASIC’s expectations for compliance with s912A(1)(aa) and discusses mechanisms for complying. However, it does not prescribe detail specific to particular types of financial services business. What constitute adequate conflicts management arrangements will depend on the nature of a licensee’s business: RG 181.10.
- 68 International standards supply the detail of conflicts management arrangements appropriate to the business of a CRA. It is highly unlikely the conflicts management obligation will conflict with any international standard or obligation for CRAs, or impose any additional regulatory cost on CRAs, as they should already have arrangements in place in compliance with the IOSCO Code and should have reviewed them in light of recent developments.
- 69 Examples of specific international standards, reports or developments addressing conflicts are:
- (a) Revised IOSCO Code provisions, such as:
 - (i) conduct formal and periodic reviews of remuneration policies and practices for CRA analysts to ensure that these policies and practices do not compromise the objectivity of the CRA’s process;
 - (ii) disclose whether any one issuer makes up more than 10% of the CRA’s annual revenue; and

- (iii) where feasible, the formal review of the methodologies and models and significant changes in these should be independent of the business lines that are responsible for rating various classes of issuers or product;
- (b) Proposed SEC rules for CRAs (Nationally Recognized Statistical Rating Organizations) (June 2008), that prohibit:
 - (i) a CRA from structuring the same products that they rate; and
 - (ii) anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it; and
- (c) Proposed EU Directive on CRAs (31 July 2008), e.g., CRAs should limit their activity to credit ratings (this would not prevent a CRA providing ‘ancillary services’ such as rating assessments of the impact on a rating of a hypothetical event).

Monitoring and updating ratings

- 70 In order for credit ratings to maintain their value to investors on an ongoing basis, CRAs must monitor and update their ratings, both periodically and in the light of new market intelligence. Ratings that are not updated to reflect the changing circumstances of the issuer and market conditions risk misleading investors as to the issuer’s creditworthiness, at least unless the CRA gives prominent disclosure that it will not be updated.
- 71 Under the IOSCO Code, once a rating is published a CRA is expected to monitor and update the rating on an ongoing basis unless the CRA makes it clear that a particular rating does not entail ongoing surveillance: IOSCO Code para 1.9.

Disclosure issues

Procedures, methodologies and assumptions

- 72 Providing the market with information about the procedures, methodologies and assumptions behind a credit rating allows investors to assess the quality of a CRA’s opinion.
- 73 Under the IOSCO Code, a CRA is expected to publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA: IOSCO Code para 3.5.
- 74 Unlike the IOSCO Code, the AFS licensing regime has few specific provisions requiring disclosures from CRAs in relation to their processes. As credit ratings are provided primarily to wholesale clients, the disclosure obligations (e.g. the FSG requirement) that would ordinarily apply in the retail context have limited application.

75 There is a general obligation on a CRA to provide its services efficiently, honestly and fairly to adequately explain its credit ratings: s912A(1)(a).

Disclosure of risks, characteristics and sensitivities of rated securities

76 If an investor has information about the key risks, characteristics and sensitivities of a security that have been factored into a credit rating, they are better placed to understand what the rating on a particular security means.

77 In this context, particular concerns have been raised that CRAs have disclosed inadequate information about individual ratings in the associated ratings announcement. For example, it has been suggested that CRAs have not made it clear to investors that there are significant limits on their ability to verify information from issuers of structured finance products. (Although disclosure is not a complete answer. If the information is inadequate, this may impact on the rating or the CRA's willingness to give a rating: see paragraph 60).

78 Further, compared to ordinary debt securities, the ratings of structured finance products are typically more complex, more sensitive to changes in underlying assumptions and subject to less verification of the originator of the security. This has prompted calls for CRAs to differentiate ratings of structured finance products from other ratings, such as through:

- (a) introducing different rating symbols or subscripts: or by
- (b) providing additional disclosure including volatility measures and risk factors.

79 The AFS licensing regime has few mechanisms for requiring disclosures about the risks, characteristics and sensitivities of financial products from persons like CRAs that are not issuers, beyond an obligation to explain its credit ratings: see the obligation for AFS licensees to act 'efficiently, honestly and fairly' s912A(1)(a).

Adequacy of organisational resources

80 Given the increasing volume and complexity of CRAs' businesses, the issue of organisational resources is critical. In order to be adequately resourced to provide well-founded and reliable ratings, a CRA requires:

- (a) staff that are competent and skilled in all the securities it rates and its models and methodologies; and
- (b) sufficient financial and human resources to monitor and update its ratings.

81 It is a common criticism that CRAs' resources have not kept pace with the sharp growth in demand for ratings of structured finance products, limiting the ability of CRAs to meet their own standards.

- 82 Under the AFS licensing regime, licensees must:
- (a) maintain their competence to provide financial services: s912A(1)(e);
 - (b) ensure that their representatives are adequately trained, and are competent, to provide financial services: s912A(1)(f);
 - (c) have adequate resources available (including financial, technological and human resources) to provide the services covered by their licence s912A(1)(d); and
 - (d) have adequate risk management systems: s912A(1)(h).

ASIC has set out general guidance on organisational capacity, competence and risk management in Regulatory Guide 104 *Licensing: Meeting the general obligations* (RG 104) and Regulatory Guide 105 *Licensing: Organisational competence* (RG 105).

- 83 Together these obligations would require a CRA to maintain staff with sufficient skills and experience, and of sufficient number to, prepare, monitor and maintain credit ratings on an ongoing basis.

Reliance on CRAs' ratings

- 84 Although ratings are useful for limiting, monitoring and communicating the credit risk that investors take, they do not wholly reflect the level of liquidity, market or volatility risk of a particular security. Institutional investors have relied too heavily on credit ratings in their investment guidelines and choices. Examples of this over-reliance include substituting ratings for independent risk assessment and due diligence, and relying exclusively on ratings for valuation.

- 85 It has also been suggested that official recognition of credit ratings in various regulatory and supervisory frameworks, both internationally and in Australia, may have encouraged investors' over-reliance on ratings, by discouraging investors from paying close attention to what the ratings actually mean.

- 86 ASIC has not relied heavily on recognition of CRAs in its regulatory policy. For example, CRAs' ratings do not form part of any regulatory definitions (e.g. for cash management trusts); they are not mandatory in a prospectus for debt issues. Nor do they play a role in ASIC's financial requirements policy for AFS licensees. However, there are two areas in which ASIC does acknowledge the role of CRAs:

- (a) Class Order (07/428) *Consent to quote: Citing credit ratings, trading data and geological reports in disclosure documents and PDS* which gives relief for securities and financial product issuers to cite credit ratings in a fundraising disclosure documents without the consent of ratings agencies; and
- (b) Benchmark 4 in ASIC Regulatory Guide 69 *Debentures—improving disclosure for retail investors* which outlines ASIC's expectations on

issuers having their unlisted debentures rated for credit risk by a recognised credit rating agency.

87 The fact that ASIC requires an explanation of the rating in both of these cases is recognition of the limitations of the credit rating as a risk tool.

88 ASIC considers that institutional investors have various duties to their members or investors to carefully consider how they use credit ratings in their investment guidelines and mandates, and for risk management and valuation. Institutional investors should conduct risk analysis commensurate with the complexity of the relevant securities and the materiality of the proposed investment.

Should retail AFS licensing protections apply?

89 Credit ratings are used by a wide variety of market participants for a variety of reasons. These users are primarily wholesale clients within the meaning of s761G of the Corporations Act. However, some users are retail clients.

90 Under the AFS licensing regime, licensees who provide financial services (including general financial product advice) to retail clients must:

- (a) provide retail clients with a FSG: s941A;
- (b) ensure that representatives providing general financial product advice on its behalf comply with the training standards set out in RG 146: PF 209 *Licence conditions* at conditions 6–9;
- (c) have an internal dispute resolution procedure and be a member of an external dispute resolution scheme: s912A(1)(g); and
- (d) maintain appropriate compensation arrangements: s912B.

91 The overriding aim of these AFS licensing obligations is to protect retail investors, by requiring a licensee to disclose key details about its business, maintain appropriately skilled staff and ensure that there are avenues of redress.

Prudential regulation

92 Credit ratings currently play an important role in the Australian prudential regulatory framework. Under APRA's capital regime for authorised-deposit taking institutions (ADIs), adopted in accordance with the international Basel II framework, credit ratings are used in risk-weighting certain assets and exposures. Credit ratings are similarly used in the regulatory capital regime for life and general insurers.

93 To date, APRA has recognised ratings provided by CRAs that are regulated by the SEC; APRA has also released guidelines setting out the eligibility criteria by which it would recognise other CRAs for purposes of the ADI

capital framework. APRA has not raised specific concerns in the course of this review about Australian CRAs, outside of noting the conclusions reached by international regulatory bodies and indicating the view that these issues need to be addressed in an international context.

D Research houses

Key points

Research houses play a useful role in the Australian financial system by providing third party analysis of financial products.

However some recent corporate collapses, involving products and funds that had received investment-grade ratings (e.g. Westpoint, Fincorp, Basis Capital), have highlighted the following issues with research houses:

- AFS licence requirements and the use of disclaimers;
- conflicts of interest;
- over-reliance on product ratings by advisers;
- disclosure issues;
- quality of the rating process; and
- monitoring and updating of ratings.

What is a research house?

- 94 Research house product ratings play an important role by assisting users to assess and compare financial products and make better-informed investment decisions, when the ratings are independent and properly explained.
- 95 There is no established definition of a research house. However, they can be broadly defined as firms that provide objective, independent ratings (except credit ratings), recommendations or opinions on financial products (e.g. managed funds, structured products, superannuation funds and insurance products). They may rate quoted or unquoted products.
- 96 While a research function can be embedded in an investment bank or stockbroker, or combined with an asset management company, this review does not cover these. Our focus is instead on the issues raised by Senator the Hon Nick Sherry in his announcement on 22 May 2008.
- 97 Research houses may be generally grouped into three broad categories:
- (a) those that provide product ratings across a broad range of financial products (e.g. managed funds, structured products etc);
 - (b) those that mainly focus on superannuation and insurance products; and
 - (c) those that cover niche markets like property and agribusinesses.

Users of research reports and product ratings

Wholesale users

- 98 Financial advisers are the main users of research houses. They use product ratings to filter the large number of financial product offerings. AFS licensees use research houses in constructing approved product lists, from which advisers or authorised representatives must select the financial product they recommend to retail clients. An investment-grade rating is required for inclusion on approved product lists. Research houses will often tender to financial advisers to provide their research. Some smaller advisers also use research houses to contract out all of their research for product selection purposes. Professional indemnity insurers of financial advisers often require that recommended products have an investment-grade rating.
- 99 Product issuers and fund managers also commission research as a way to promote their products or funds.
- 100 Financial advisers, trustees and employers also use research houses in the superannuation context, to assist in the selection of suitable funds.

Retail users

- 101 While the main users of research reports and product ratings are wholesale, some retail clients also use research house reports and product ratings when making decisions about financial products. Financial advisers sometimes include part or all of a research report in Statements of Advice (SoAs) when recommending a financial product.
- 102 Retail clients are also exposed to product ratings that are published in newspapers or quoted in advertisements. In response to this development, ASIC has recently published guidance on the use of ratings in property and mortgage scheme advertising.

Note: see Regulatory Guide 45 *Mortgage schemes—improving disclosure for retail investors* (RG 45) at RG 45.129-RG 45.130 and Regulatory Guide 46 *Property schemes—improving disclosure for retail investors* (RG 46) at RG 46.129-RG 46.130.

- 103 For superannuation products, some research houses offer their subscription services direct to retail clients. ASIC understands that some research houses also intend to offer subscription services (e.g. via their website) direct to retail clients across a broader range of financial products (e.g. managed funds). This will make explanation and comparability of product ratings from different research houses more important.

Australian market context

Business models

- 104 Most research houses operate a combination of issuer-pays (i.e. fund managers pay a fee to be rated) and subscription-based business models. We are aware of only two research houses that currently operate a pure subscription-based business model.
- 105 In addition to their main business of research, some firms also generate revenue from non-ratings businesses like consultancy services (e.g. funds manager selection, asset allocation) and adviser training. A limited number also operate managed account services and fund management businesses.

Rating system

- 106 There is no consistent approach to the ratings system used by research houses. Some research houses use an alpha style rating system (e.g. AA), while others use star rating systems, recommendation systems (e.g. highly recommended, recommended etc) and buy/sell recommendations. In some cases product ratings may be presented in the form of a 'ranking' of product providers, rather than an absolute assessment of quality.
- 107 Given these differences in rating systems, comparing product ratings between research houses may be difficult for retail users.

Competition

- 108 Research houses claim the Australian research market is highly competitive compared to Europe, the UK and the US. We have heard that this is because of the large number of financial products available in Australia and compulsory superannuation.
- 109 Both research houses and issuers claim that these competitive forces help ensure robust research processes.

Research houses and recent collapses

- 110 The collapse of property finance companies like Westpoint and Fincorp has highlighted the possible risks faced by users of research reports and product ratings. For example, certain Westpoint products had investment-grade ratings before their collapse.
- 111 Beyond the property sector, research houses also provided investment-grade ratings to two of Basis Capital's hedge funds before their collapse. As reported in the media, the major criticism levelled at research houses arising

from the Basis Capital hedge fund collapse was that they did not understand the risks associated with the underlying investments and were too slow in down-grading their ratings when the funds faced difficulties.

Regulation of research houses in Australia

- 112 Research houses that give financial product advice by publishing product ratings must hold an AFS licence with the appropriate authorisation. As AFS licensees, research houses have general obligations which include:
- (a) providing the financial service efficiently, honestly and fairly: s912A(1)(a);
 - (b) having adequate arrangements in place to manage conflicts of interest: s912A(1)(aa);
 - (c) complying with the conditions on their licence: s912A(1)(b);
 - (d) complying with the financial services laws: ss912A(1)(c) and (ca);
 - (e) having adequate resources to provide the financial services covered by their licence and to carry out supervisory arrangements: s912A(1)(d);
 - (f) maintaining the competence to provide the financial services covered by their licence (s912A(1)(e)); and
 - (g) ensuring that their representatives are adequately trained and competent to provide those financial services (s912A(1)(f)).
- 113 Research houses also have disclosure obligations where they provide financial product advice to retail clients. This includes the obligation to provide a Financial Services Guide (FSG): s941A. Where a research house gives general advice to retail clients through an intermediary (e.g. a financial adviser), it may constitute a secondary service requiring the research house to provide the retail client with an FSG for its research services.
- Note: See attachment to ASIC Information Release 04-78: Our guidance on secondary services provision and complying with the Act.
- 114 The overriding aim of these AFS licensing obligations is to protect retail clients, by requiring a licensee to disclose key details about its business, maintain appropriately skilled staff and ensure that there are avenues of redress.

Key regulatory issues

- 115 Initial discussions with research houses, financial advisers, industry associations and consumer groups have identified the following key regulatory issues:

Table 2: Summary of key regulatory issues

Licensing and disclaimers	<p>Some research houses believe they do not need to be licensed because they are not providing financial product advice.</p> <p>Some research houses (including those holding an AFS licence) use disclaimers to suggest that they do not provide financial product advice or to limit their liability for the product rating they provide (e.g. the research house will not be liable for any loss incurred through reliance on the report).</p>
Conflicts of interest	<p>Research houses operate a primarily issuer-pays business model: they derive income from fees paid by the issuers of the products that the research houses rate. This can be perceived as a disincentive for research houses to provide negative ratings.</p> <p>Some research houses also provide non-rating services (e.g. consulting services).</p>
Over-reliance on product ratings by advisers	<p>We have heard that some financial advisers may be over-relying on research house ratings when providing financial advice to retail clients e.g. because they are 'time-poor' or unable to conduct their own research.</p>
Disclosure issues	<p>There may be a lack of transparency about what product ratings mean or the methodology used to arrive at the product rating.</p>
Quality of ratings process	<p>There may be issues with the skill and experience of research house analysts because of high staff turnover or because of the complexity of financial products.</p>
Monitoring and updating of ratings	<p>Recent corporate collapses have raised concerns with the monitoring and updating of product ratings in a timely manner.</p>

Licensing and disclaimers

- 116 Research houses are required to hold an AFS licence as they provide financial product advice. We are aware that some research houses may be operating without an AFS licence on the basis that they do not provide financial product advice.

Note: Financial product advice is defined as a recommendation or statement of opinion that intends to (or could reasonably be regarded as intending to) influence a person in making an investment decision about a financial product: s766B.

- 117 Information that is solely factual (i.e. objectively ascertainable information whose truth or accuracy cannot be questioned) is not financial product advice and as such does not require an AFS licence. ASIC has previously stated that factual information that is presented in a manner that may imply a recommendation to buy, sell or hold a particular financial product or class of

financial products, is financial product advice: see Regulatory Guide 36 *Licensing: Financial product advice and dealing* (RG 36).

118 Most research houses use disclaimers in their research reports or when providing product ratings. Disclaimers do not, of themselves, determine whether a communication constitutes financial product advice: see RG 36.

119 ASIC has provided guidance about the use of disclaimers in expert reports. Disclaimers in reports which purport to exclude or limit the statutory liability of an expert defeat the purpose of the report and may be misleading: see Regulatory Guide 111 *Content of expert reports* (RG 111).

120 Similarly, we are of the view that research houses that provide general advice when giving a product rating cannot disclaim their statutory obligations or limit their statutory liability through disclaimers and doing so may be misleading.

Conflicts of interest

121 As AFS licensees, research houses are required to have adequate arrangements for managing the conflicts of interest that may arise in relation to the provision of product ratings: s912A(1)(aa).

122 At this stage ASIC is not proposing to give further, specific guidance about conflicts management by research houses. We have previously given guidance on the conflicts management obligation, as outlined below.

Guidance for research providers

123 Regulatory Guide 79 *Managing conflicts of interest: A guide for research providers* (RG 79), expressly applies to research houses, although the background to RG 79 was primarily investment bank securities analysts.

Note 1: see e.g. *Commentary on draft provisions (CLERP (Audit Reform and Corporate Disclosure Bill) (2003)* and ASIC Report 24 *Research analyst independence* (2003).

Note 2: RG 79 supplements Regulatory Guide 181 *Licensing: managing conflicts of interest* (RG 181)

124 A research house is a 'research report provider', an AFS licensee that provides research reports to other persons: RG 79.1.3. A 'research report' includes a product rating (RG 79.1.1 and 79.1.2). It is:

- (a) general advice that includes an express or implied opinion or recommendation about a named or identifiable investment product; and
- (b) intended to be, or could reasonably be regarded as being intended to be, broadly distributed (whether directly or indirectly) to users (whether wholesale or retail).

- 125 Product ratings are distributed to financial advisers as wholesale users. They are also distributed to retail users either directly, for example, available by subscription from a research house website or indirectly by financial advisers or extracted in SoAs.
- 126 Possible conflict issues for research houses raised in our initial consultation are:
- (a) primarily issuer-pays business model; and
 - (b) provision of non-investment rating business (i.e. consulting services).

Issuer-pays business model

- 127 Most research houses rely, primarily or partially, on an issuer-pays business model. They derive income from fees paid by the issuers of the products that the research houses rate. As most research houses are dependent on issuers for research income, this creates a disincentive for them to provide negative ratings or research reports.
- 128 To manage conflicts of interest, research houses should disclose whether they (or any associates) are likely to receive any benefits from the report. These can be fees charged for a product rating and research report or fees charged for the use of the rating by the issuer, for example, in advertisements.
- 129 Disclosure should generally cover the nature and extent of the benefit, for example, compensation received by the research house from the subject of the report: RG 79.3.9 and RG 181.54. Research houses should give this disclosure:
- (a) during the process of contracting with financial advisers to supply product ratings and research. (We acknowledge that the disclosure a research house may need to give to a financial adviser, as a wholesale client, may be less detailed than for a retail client: RG 181.58 and RG 79.3.3);
 - (b) in or accompanying product ratings or research reports; and
 - (c) if the product rating is likely to be distributed to a wide range of end-users (e.g. through the media), on the research house's website.

- 130 Some research houses have told us that as part of their conflicts management arrangements they ensure that no analyst has involvement in discussions with issuers on fees.

Consulting and other investment services

- 131 Some research houses also offer non-rating investment services, e.g., consulting services on investment manager selection and asset allocation, or other investment services such as offering a 'fund of funds'. Robust

information barriers may help a research house that provides such services to manage conflicts of interest: RG 79.2.11. The research house should disclose any other services it provides to the product issuer: RG 79.3.4(c).

Over-reliance on product ratings by advisers

- 132 Product ratings may be an efficient way of screening financial products. However, recent corporate collapses have highlighted the issue whether some financial advisers may be over-relying on the information provided by research houses.
- 133 Financial advisers are required to assess whether the financial product is suitable for the specific circumstances of the retail client when providing personal advice: s945A(1)(a). This requires an understanding of the financial product that it recommends.
- 134 Financial advisers are also required to consider and investigate the subject matter of the advice they provide: s945(1)(b). While, in some circumstances, it may be reasonable for an adviser to rely on information supplied by research houses, financial advisers should take reasonable steps to ensure that the research is accurate, complete, reliable and up-to-date: see RG 175 *Licensing: Financial product advisers – Conduct and disclosure* (RG 175).

Disclosure issues

Methodologies, criteria and assumptions

- 135 Research houses adopt different methodologies, criteria and assumptions when rating a financial product. For example, some research houses undertake quantitative research (e.g. by analysing historical performance), while others conduct both quantitative and qualitative analysis. In addition, research houses may undertake their research differently. For example, research houses may conduct quantitative research using relative returns or absolute returns while qualitative analysis may differ because of different criteria are used or because different weightings or assumptions are used in the analysis.
- 136 Ratings of superannuation and insurance products may focus on particular product features and ease of claim in the case of insurance products in their assessment of the financial product. Focus on product features may encourage a climate among product providers of continual product revision without due regard to legacy issues. Ease of claims is an important issue for consumers, but this focus in ratings may have implications for providers' risk management in dealing with claims. The methodology for superannuation products also covers organisational capacity, administration, fees and insurance.

137 Differences in evaluation models affect comparability of ratings between different research houses. As product ratings may not be comparable between research houses, it may lead retail users (and some advisers) to misunderstand them (e.g. a five-star rating from one research house may not be comparable to a five-star rating from another). This risk is greater where the rating is for retail consumption (i.e. used in advertisements or SoAs).

138 Because product ratings may not be uniform, ASIC expects research houses to clearly explain the methodology, criteria and any assumptions used in the research report. The research house should also explain its methodologies and criteria in its FSG. We consider that a research house report that does this allows users to better understand the rating or opinion and decide the weight to be attached to the report. Research houses have an obligation to explain their advice: 'efficient, honest and fair': s912A(1)(a). Ratings may be misleading where they are not properly explained.

Publishing non-investment grade ratings

139 Whether research houses should be required to publish non-investment grade ratings was also raised during initial consultation. Some research houses have told us that all ratings (including negative ratings) are published once they have been formally engaged. Others have said that they do not publish negative ratings because of the threat of litigation by issuers. This may not be a major concern because failure to obtain an investment-grade rating, whether published or not, means the product will not appear on approved product lists. However, the non-publication of negative ratings may facilitate 'ratings shopping'.

Quality of the ratings process

140 Published surveys have suggested that research analyst turnover and inexperienced staff may be compromising the quality of research house ratings.

141 Research houses should critically assess information provided to them by issuers that underpins their product ratings. AFS licensees have general obligations to:

- (a) do all things necessary to ensure that their financial services (including advice) are provided efficiently, honestly and fairly: s912A(1)(a);
- (b) take steps to ensure that they comply with the financial services laws: s912A(1)(c) & (ca);
- (c) maintain the competence to provide those financial services: s912A(e); and
- (d) ensure that their representatives are adequately trained, and are competent, to provide financial services: s912A(1)(f).

Implicit in these obligations is a requirement that general financial product advice (such as product ratings) should be prepared by skilled and experienced staff, be based on reasonable grounds and not be misleading.

- 142 Further, research houses who fail to adopt ‘reasonable measures’ to ensure the quality of their ratings process may be subject to sanctions for engaging in misleading or deceptive conduct, or making false or misleading statements, in relation to financial services and products (see s1014E and s1041H Corporations Act; ss12DA-12DB ASIC Act). Research houses make an implied assertion in issuing product ratings that the opinion has a reasonable basis, is the result of the exercise of due care and skill, and can be relied on: see RG 79.2.26.
- 143 RG 79 also says research report providers should ensure that research reports are based on objective, verifiable facts and analysis: RG 79.2.26-7. There is also an analogy with expert reports and ASIC’s expectation that experts should set out the ‘reasonable grounds’ they have relied on in forming an opinion: see RG 111.

Monitoring and updating ratings

- 144 Inadequate monitoring and updating of ratings in a timely manner were issues raised following recent corporate collapses.
- 145 Product ratings that are useful to users on an ongoing basis should be monitored and updated periodically and in response to changing market conditions. Ratings that are not monitored or updated can be misleading unless research houses specifically and prominently state that the rating will not be updated.
- 146 Some research houses claim that this issue has been addressed by conducting sector reviews to identify systemic issues and ensuring that they have sufficient resources to conduct product reviews where market conditions change.
- 147 While the AFS licensing regime does not contain a specific obligation requiring licensees (including research houses) to monitor and update their ratings, research house ratings may be misleading where they are not monitored or updated.