

# SEC Credit Rating Reforms Differentiate Asset-Backed Securities Products

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## Introduction

Recognizing that uncertainty about the accuracy of credit ratings had contributed to the current financial crisis, the SEC recently adopted rules reforming the credit rating process. [Release No. 34-59342](#) (2-2-09). The new rules, effective April 10, 2009, seek to restore the integrity of the process by which NRSROs rate structured finance products, particularly mortgage related securities.

The financial crisis occurred, in part, because credit rating agencies awarded their highest ratings to complex debt instruments that did not merit investment grade status. Many investors in mortgage-backed securities and collateralized debt obligations relied heavily on the credit ratings in making their investment decisions and in communicating risk appetites to their investment managers, rather than undertaking their own independent credit analyses of these complex instruments. When it became apparent that even AAA tranches of asset-backed securities could face large write-downs, investors lost faith in the ratings of a broad range of complex structured products. And, no longer willing to rely on ratings and unable to perform their own credit analyses, investors simply pulled back from a wide range of structured product markets.

The rating agencies certainly were not the only cause of the current crisis, but it is becoming apparent that they played a significant role. The conflict-of-interest issue looms large on both sides of the Atlantic. Recently, the European Commission proposed the regulation of credit rating agencies under a series of sweeping measures designed to restore confidence to the markets.

After nearly a century of self-regulation, the rating agencies became subject to SEC oversight after the enactment of the [Credit Rating Agency Reform Act of 2006](#). The Act

authorizes the SEC to oversee credit rating agencies registered with the Commission as nationally recognized statistical rating organizations (NRSROs). The Commission has actively used its authority from the very beginning. Starting in August 2007, the SEC staff conducted a comprehensive, year-long inspection and examination of the rating agencies and produced a public report detailing considerable deficiencies. That inspection, in part, informed the adoption of the current rules.

The SEC has continued the regulatory reform of the credit rating agencies with a set of new requirements focusing heavily on the complex structured products whose ratings were at the center of the financial crisis. The SEC thus embraces the doctrine of differentiation, which is also being adopted by the European Commission in its reform of credit rating agencies. The changes are designed to improve the quality of credit ratings by fostering accountability, transparency, and competition in the credit rating industry, particularly with respect to credit ratings for structured and asset-backed financial products.

In the new rulemaking, the Commission has: enhanced the disclosure of credit ratings performance measurement statistics; increased the disclosure of information about the assets underlying structured finance products; required more information about the procedures and methodologies used to determine structured finance ratings; and addressed conflicts of interest arising from the structured finance rating process.

## Registration Process

Exchange Act Rule 17g-1 prescribes a process for a credit rating agency to register with the Commission as an NRSRO using Form NRSRO and requires agency to publicly disclose certain information. Form NRSRO is also the means by which NRSROs update the information they must disclose.

The SEC amended the instructions to Exhibit 1 of the form to require NRSROs to provide more detailed performance statistics, thereby making it easier for users of credit ratings to compare the ratings performance of the NRSROs. In addition, these amendments will make it easier for an NRSRO to attract clients by demonstrating that it has a superior ratings methodology.

One change to the Exhibit 1 instructions would require an NRSRO, when generating the performance statistics, to include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Another change would require that the class-by-class disclosures be broken out over 1-, 3- and 10-year periods.

Yet another change to the Exhibit 1 instructions would clarify the type of ratings actions that are required to be included in these performance measurement statistics. Specifically, it would replace the instruction requiring that the performance statistics show downgrade

and default rates with an instruction that they show ratings transition and default rates. The switch to ratings transition rates from downgrade rates was designed to clarify that upgrades (as well as downgrades) should be included when generating the statistics.

The SEC also amended the instructions to Exhibit 2 of Form NRSRO to provide greater clarity around three areas of the NRSROs' rating processes that have raised concerns in the context of the recent credit market turmoil: (1) the verification of information provided in loan documents; (2) the quality of loan originators; and (3) the ongoing surveillance of existing ratings and how changes made to a model used for initial ratings are applied to existing ratings.

This additional information will assist users of credit ratings in making more informed decisions about the quality of an NRSRO's ratings processes, particularly with regard to structured finance products.

### *Level of Verification*

The rating agency must disclose information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction relied on in determining credit ratings. The Commission believes this disclosure will benefit users of credit ratings by providing information about the potential accuracy of an NRSRO's credit ratings.

NRSROs determine credit ratings for structured finance products based on assumptions in their models as to how the assets underlying the instruments will perform under varying levels of stress. These assumptions are based on the characteristics of the assets (e.g., value of the property, income of the borrower) as reported by the arranger of the structured finance product. If this information is inaccurate, the capacity of the model to predict the potential future performance of the assets may be significantly impaired. Consequently, information about whether an NRSRO requires that some level of verification be performed or takes other steps to account for the lack of verification or a low level of verification will be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by inaccurate information about the assets underlying a rated structured finance product.

### *Quality of Originators*

The rating agency will also have to disclose whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings. Originators of assets were key players in the originate-and-distribute securitization process that contributed to the financial crisis.

The Commission believes that certain qualities of an asset originator, such as its experience and underwriting standards, may impact the quality of the loans it originates and the accuracy of the associated loan documentation. This, in turn, could influence how the assets ultimately perform and the ability of the NRSRO's models to predict their performance.

Consequently, the failure to perform any assessment of the loan originators could increase the risk that an NRSRO's credit ratings may not be accurate. Therefore, disclosures as to whether the NRSRO performs any qualitative assessments of the originators would be useful in comparing the efficacy of the NRSROs' procedures and methodologies.

### *Surveillance*

Finally, the SEC will require rating agencies to disclose how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

On a more macro level, the Commission believes that these enhanced disclosures in the exhibits to Form NRSRO will make it easier for market participants to select the NRSROs that are performing well and have the highest-quality processes for determining credit ratings. The Commission expects that providing market participants with enhanced disclosures will lead to increased competition and the promotion of capital formation through a restoration of confidence in credit ratings.

### **Books and Records**

Exchange Act Rule 17g-2 requires an NRSRO to make and keep current certain records relating to its business and requires an NRSRO to preserve those and other records for certain prescribed time periods. The SEC amended Rule 17g-2 to provide greater documentation of the ratings process to assist Commission staff in their examination function as well as to provide greater information to users of issuer-paid credit ratings about the performance of an NRSRO's issuer-paid credit ratings.

The additional records will be: (1) a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating for a structured finance product; (2) a record showing the history and dates of all

previous rating actions with respect to each outstanding credit rating; (3) a record, to be made publicly available, showing the history and dates of a 10% random sample of all previous rating actions for each ratings class for which an NRSRO is registered and has issued 500 or more issuer-paid credit ratings; and (4) a record of any written complaints regarding the performance of a credit analyst in determining credit ratings. These records will assist in monitoring whether an NRSRO is operating consistently with the methodologies and procedures it establishes to determine credit ratings and its policies and procedures designed to ensure the impartiality of its ratings, including its ratings of structured finance products.

In addition, changes to Rule 17g-2(d) will require an NRSRO to make publicly available a random sample of 10% of the issuer-paid credit ratings actions histories, in an XBRL format and with a six-month grace period, for each ratings class for which it has issued 500 or more issuer-paid credit ratings. This XBRL disclosure requirement will allow the marketplace to better compare the performance of different NRSROs that determine issuer-paid credit ratings, since it will shift the source of data formatting from end-users to NRSROs submitting interactive data, thus eliminating the need for end-users to make interpretive decisions on how to compare data fields across NRSROs' reported rating histories. This additional disclosure also may make NRSROs more accountable for their issuer-paid credit ratings by enhancing the transparency of their ratings performance.

The Commission believes the XBRL format will benefit market participants seeking to develop their own performance statistics using the ratings history data to be made public by the NRSROs because it will require the NRSROs to present the information in a standard format. Making the information available in an XBRL format will facilitate the process of creating better and more useful means to analyze how a given NRSRO performed in a certain class of issuer-paid credit ratings and compare that broader performance across NRSROs subject to the public disclosure rule, thus encouraging competition within the industry.

## Financial Reports

Exchange Act Rule 17g-3 requires an NRSRO to furnish certain financial reports to the Commission on an annual basis, including audited financial statements as well as other financial reports. Changes to Rule 17g-3 will require an NRSRO to furnish an additional annual report to the Commission: an unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) taken during the fiscal year in each class of credit ratings identified in Section 3(a)(62)(B) of the Act for which the NRSRO is registered with the Commission.

The new report is designed to enhance the Commission's oversight by providing the Commission with additional information to assist in the monitoring of NRSROs for compliance with their stated policies and procedures. For example, the proposed new

report will allow examiners to target potential problem areas in an NRSRO's rating processes by highlighting spikes in rating actions within a particular class of credit rating.

## Conflicts of Interest

Changes to Exchange Act Rule 17g-5 will prohibit an NRSRO from issuing or maintaining a credit rating where: the NRSRO or an affiliate provided recommendations on the structure of the transaction being rated; a credit analyst or person involved in the ratings process participated in fee negotiations; or a credit analyst or a person responsible for approving a credit rating received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities that have an aggregate value of no more than \$25.

The Commission believes that the Rule 17g-5 amendments will promote the disclosure and management of conflicts of interest and mitigate potential undue influences on an NRSRO's credit rating process, particularly with respect to credit ratings for structured finance products. These amendments will, in turn, increase confidence in the integrity of NRSRO ratings and, thereby, promote capital formation. □

## About the Author

**James Hamilton** is a Principal Analyst at [Wolters Kluwer Law & Business](#), a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation, at <http://jimhamiltonblog.blogspot.com>). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

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