

### **Austin Rating Comments on the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies**

Austin Rating wishes to express its gratitude to the International Organisation of Securities Commissions (IOSCO) and its task force on Credit Rating Agencies (CRAs) for the opportunity given to us to express our view on the Code of Conduct Fundamental for Credit Rating Agencies. Austin Rating has been on the rating business since 1986, operating exclusively on the Brazilian market. We have issue more than 200 ratings for a variety of issuers (and issues), from financial strength ratings for financial institutions and corporates to fix income securities ratings. We believe to be the largest rating firm, when measure by the number of local ratings, operating in Brazil.

First of all, we would like to express our recognition to the work conducted by IOSCO and other international organisations, specially the Basle Committee and the Bank of International Settlements, on the activities of Credit Rating Agencies. We have closely accompanied the evolution of the literature on the subject since the late 90s and we believe that the work produced by these institutions has helped to enlighten issuers, investors, regulators and other market participants on the activities of CRAs. These institutions have also served to make the public more aware of the potential positive externalities of the work of CRAs, especially in reducing information asymmetries between investors and issuers, reducing capital cost for issuers, and helping to better understand and monitor risks. These institutions have also generated a space of dialogue, studying and discussing issues that potentially affect the rating industry, from issues regarding pro-cyclicality of ratings, herd behaviour and the failure to timely predict defaults to issues regarding the transparency and credibility of CRAs. We constantly review and monitor this literature and any other developments in the rating industry and make constant efforts to address these issues.

IOSCO has asked us to comment on three issues: our view regarding the proposed Code of Conduct Fundamentals for Credit Rating Agencies; our view on issues regarding the disclosure (ex-ante) of modifications to the rating methodology and our view on institutional regulatory arrangements enforcing the compliance with the principles laid on its Code of Conduct.

It is our opinion that the IOSCO code represents a very useful tool for implementing a set of "core principles" that CRAs could adopt into their own codes of conduct, and in their operational and business policies. We believe that the Code can significantly contribute to enforce compliance with the principles concerning the credit rating industry sat in the "Report of the Activities of Credit Rating Agencies" (IOSCO, 2003). We believe that the IOSCO Code will contribute to enhance the credibility and integrity of the rating industry.

Austin Rating believes that any debate regarding the regulation of the rating industry and the enforcement of the IOSCO Code must be widely discussed by all industry members: all rating agencies in the local market, investors, issuers and regulators. It is essential that the debate on these two items be conducted in a local context. This debate must be democratic, allowing all parties to express their view and avoiding its capture by a reduced numbers of CRAs.

Austin Rating believes that the credit rating industry can become a good example of the efficiency of market regulatory arrangements. The features of credit rating industry contribute to this type of regulatory mechanisms. We base this belief on the basic cornerstones of our business: maintaining our quality (this, by efficiently measuring and monitoring risk) and our integrity (implementing policies to allow us as to keep our independence and our objectivity). We believe that agencies under performing in these two items will be efficiently identified by the market and promptly excluded from it. However, for the well functioning of such mechanism it is essential to create a levelled and inclusive playing field. Any type of regulatory arrangements must encourage competition and recognise the particularities of the local market. For a regulatory market arrangement to be effective it is essential that the local industry adopts an "Industry Code of Best Practise", using, as an inspiration, the core principles sat by the IOSCO Code of Conduct. As mentioned above, the designing of such code must be largely

discussed by the whole industry and constructed on consensual basis. In parallel, CRAs must adopt (unilaterally) and disclose their own codes of conduct applying to the specific market where they participate. CRAs should also disclose their rating policies, methodologies and other operating procedures that could result in a better understanding of their activities by the market. We would like to underline that for such evolution to be truly effective the issues relating to copyrights and property rights could represent an obstacle to full disclosure.

We believe that the best mechanism to construct an Industry Code of Best Practise is to create a debate forum in which all CRAs operating in the local market participate. This “association” of CRAs can use the IOSCO code as a work frame, using its underlying principles as a guide for the elaboration of its own Industry Code. All firms in the local market would have to agree to comply with the Industry Code of Best Practise. This code must be elaborated taking into account the particularities and features of the local market. Before a legal agreement to comply is enforced, the Industry Code of Best Practise must be widely discussed by all participants in the industry. The main aim of this Code must be to protect the integrity and the credibility of the rating industry. The Code of Best Practise must explicitly describe a set of mechanisms to ensure compliance by CRAs, these could take different forms, from peer group monitoring to third parties enforcing compliance.

Austin Rating believes that when defining any regulatory arrangement, or when designing an Industry Code of Best Practise or individual codes of conduct the following objectives must be aimed: independence, credibility, reliability, integrity, quality, respect (for issuers and the investing public) and transparency.

Regulators must be aware that efforts to comply with regulations could be relatively larger for small domestic CRAs than for large international firms operating in local markets (with local rating scales). This must be considered when designing any regulatory arrangements.

As we mentioned before, we believe that the IOSCO code can be considered as a reference for industry or individual codes of conduct, however we believe that it cannot be regarded as a fix (orthodox) rule. In the introduction to its code, IOSCO expresses this view. Equally, any Industry Code of Best Practise must include strong guidelines aiming to offset predatory practises of competition which could compromise the quality and (or) scope of the (rating) analysis (i.e. attributing better ratings to gain market share) and which could undermine its viability.

CRAs must develop and publish their own code of conduct fundamentals, underlying their methodologies of analysis, their process and practises aiming to reassure the public on their independence and their competence. A compliance officer must be named in each CRA to ensure compliance with the internal code of practise and with the Industry Code of Best Practise.

We would also like to stress that any code of conduct or regulatory arrangement should not serve as a barrier to entry (the industry) for new rating firms or be discriminative against CRAs with shorter track records. This would materialise in a less competitive market arising from the early consolidation and concentration of the rating industry. A competitive rating industry will enhance the effectiveness of market regulation, avoiding oligopolistic practises and allowing for comparability between different risk classifications.

The regulatory debate, or any discussion regarding the adherence to either an Industry Code of Best Practise or to the IOSCO code at individual CRA level must not translate into a judgement of the CRA methodology or procedures. What must be relevant is that the rating assigned translates into an accurate risk classification, adjusted to the real level of risk of the issuer. As IOSCO states it “one method of analysis is not necessarily superior to another”. We believe that adopting single or limited analysis criteria would constitute a grave error for the rating industry.

Depending on the importance of CRA's opinions on local markets, registering procedures may have to be introduced. We agree with IOSCO's view that if registering procedures are introduced by regulators, these can be inspired on the “eligibility criteria” developed by the Basel Committee on its New Basel Capital Accord (“International Convergence of Capital Measurement and Capital Standards”, June 2004). Such move would have to be coupled with actions taking into account the local particularities of the rating industry. Again, the registering

criteria must foster industry competition avoiding the constitution of oligopolies and must not discriminate for type of agency, track record or methodology of analysis. We believe that regulators must allow CRAs sufficient time and provide guidance to achieve full compliance with registering rules.

We also believe that any debate regarding the regulation of the industry has to be protected from becoming a marketing or commercial battleground for CRAs. This can compromise the scope and efficiency of the resulting regulatory arrangement.

Regarding the proposed Code of Conduct Fundamentals we agree with most of the principles put forth by IOSCO. However, we would like to comment on certain specific issues of the Code:

- We fully agree with the proposals regarding the quality and integrity of the rating process. We believe that the IOSCO proposals considerably serve to improve the transparency of the rating process. However, we would like to stress that no “dogma” concerning analysis methodologies (or criteria) must be adopted by regulatory arrangements. Analysis methodologies must be allowed to vary from one CRA to another (without, of course, compromising the quality of the risk analysis). We support the proposal to validate ratings based on historical experience, however building default probability per risk category implies extensive data series (for the resulting probability to be accurate). Default probabilities take time to build in countries where the rating industry has a short track record. When designing defaults probabilities, regulators must ensure that these are based on the local rating scales (in markets where large international firms participate issuing ratings in “local scales”, as is the case of Brazil). Equally, we believe that in the medium term CRAs could disclose their transitional matrix, however these must also be based on the local rating scale.
- Regarding the item “Independence and Avoidance of Conflicts of Interest”, we agree with the principle of “maintaining substance and appearance of independence”. Nonetheless, there are situations in which an apparently conflicting situation does not materialise in loss of independence and (or) objectivity. For the purposes of compliance with Industry Codes of Best Practise, Individual Codes of Conduct or any regulatory issues, certain conflicting situations may have to be analysed case by case. We also consider that creating too many “Chinese Walls” (mechanisms and procedures seeming to mitigate conflicts of interest) may not be worth adopting it if they do not serve their purposes. Furthermore, these can introduce too many “technicisms” (to regulatory mechanisms) that can be too complicated to enforce , especially for small size CRAs. We also believe that the definition of what constitutes a conflict of interest has to be discussed and defined in a debate including all CRAs in the local market. Although we believe that written procedures defining the firm’s policy in dealing with conflicts of interest is essential, we consider that the firm ethics will, at the end of the day, dictate how the firm deals with conflicts of interest or any other items affecting (or seeming to affect) its independence. As we pointed out earlier, we do believe that the market will positively select firms with good and strong ethical behaviour.
- Although we thoroughly agree with the fact that CRAs should not refrain “from taking a rating action based on the potential effect of the action”, we would like to stress that CRAs must respect all issuers they rate. CRAs should adopt a responsible position when taking decisions that significantly affect an issuer. Downgrades or upgrades must be thoroughly justified, and, prior to their adoption, the CRA should engage in all procedures allowing it to fully understand the true situation of the issuer and any other developments affecting the rating. CRA must not take “safe decisions” marked by an over conservative bias as “safe decision rule”. CRAs must not use their size, influence and notoriety to discriminate against smaller issuers (i.e. in order to adjust their rating scale, their transitional matrix, to appear to be conservative etc).
- We believe that CRA must not yield to issuer pressures concerning rating actions. However, small size and CRAs with shorter track records may be more vulnerable to pressure from issuers. To efficiently avoid this, local CRAs could associate to develop mechanism aiming to reduce the frequency of these events and penalise such actions. A constant dialogue with issuers and investors could be engaged aiming to reduce such approaches.

- We completely agree with IOSCO's proposals regarding the responsibilities of CRAs with the investing public and issuers, especially those regarding the transparency of the rating process. Here we underline, as mentioned above, that rating agencies must carry out an extensive analysis of the issuer before assigning a rating and that the issuer must be able to verify the scope of understanding of the CRA of its situation in order to avoid misperceptions.
- CRAs must respect the confidentiality of the information provided by the issuers. However we consider that the main objective of CRAs is to reduce information asymmetries between issuer and investors. Considering this, we believe that a good equilibrium must be achieved, reassuring investors on the completeness of the rating analysis and motivating issuers to disclose better quality information. Investors can not be penalised by confidentiality contracts that impede the disclosure of information that can significantly affect their investment decisions.

Given the scope and relevance of the IOSCO code for the rating industry, this document cannot represent our complete opinion on the matters for which IOSCO has consulted us. We remain available to explain any doubts or questions you may have about these comments and we reaffirm our commitment with any discussion helping to improve the efficiency, transparency and independence of the credit rating industry.

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