

Credit Rating Agencies: The New Kids On The Regulatory Block

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Between 2000 and 2009, \$4 trillion in Collateralized Debt Obligations (CDOs) were issued. Ratings agencies were paid fees which were based on a percentage of the total value of the CDOs which they rated. The fees which ratings agencies were being paid were so good that the competition to get the job to rate subprime products was intense.

The raft of rule changes which the DFSA introduced in July of this year, not surprisingly included rules devoted specifically to credit rating agencies. Operating a Credit Rating Agency is now, a new type of financial service in the DIFC.

In its explanation for the creation of this new category of financial services, the DFSA quite correctly were of the view that it was inappropriate that all of the rules regulating other financial services, should also apply to Credit Rating Agencies. So, for example, Credit Rating Agencies are not subject to capital requirements, not required to appoint an MLRO, they do not need to have complaint handling procedures or obtain the consent of the DFSA in relation to a change of control, and they are not subject to the client classification requirements.

So what rules do apply to Credit Rating Agencies?

Consistent with the rules relating to other financial services, the rules regulating Credit Rating Agencies are found in GEN and COB.

The GEN module now lists “operating a Credit Rating Agency” as a new financial service in the DIFC.

Rule 2.27.1 defines what is “operating a Credit Rating Agency” which is essentially “undertaking one or more Credit Rating Activities for the purpose of producing a Credit Rating with a view to that Credit Rating being disseminated to the public or distributed to a Person by subscription, whether or not it is in fact disseminated or distributed.”

The exclusions from the definition of “Operating a Credit Rating Agency” include services like credit scoring systems or similar assessments relating to obligations arising from consumer, commercial or industrial relationships, on the basis that these services are not relied upon by the public. The DFSA advises that their approach is consistent with the approach which was adopted in the EU, Hong Kong and Singapore.

The principles which apply to all Authorised Firms as set out in rule 4.2 of the GEN module, also apply to Credit Rating Agencies. In addition there are now Credit Rating Agency specific principles found in COB at 8.2.

There are three overarching principles introduced in these Rules (8.2.1, 8.2.2 and 8.2.3). These are set out below.

Rule 8.2.1 requires that a Credit Rating Agency ensure that its Credit Ratings are well founded and based on a fair and thorough analysis of all relevant information.

Rule 8.2.2 requires that the decisions of a Credit Rating Agency to do with Credit Ratings are independent and free from political or economic pressures and not affected by conflicts of interest to do with ownership

structure, business or other activities or conflicts of interest of its employees.

The final principle in Rule 8.2.3 requires a Credit Rating Agency to conduct its Credit Rating Activities in a transparent and responsible manner.

There are then extensive rules relating to the quality of the Rating Process (8.3), the integrity of the credit rating process (8.4), conflicts of interest and independence (8.5) and independence of rating analysts and other employees (8.6). In this section one of the more interesting rules is 8.6.6 which requires that a Credit Rating Agency ensure that its employees not be remunerated and ensure that their performance evaluations are not conducted on the basis of the revenue generated or expected from the credit ratings in which the employee was involved.

Also of interest is the definition of "Rating Subject" in 2.27.3 which provides that a Rating Subject is a Person other than a natural person, a credit commitment or a debt or debt-like Investment. The significance of this is that COB 8.1.1(2) makes it clear that where a Rating Subject is some kind of financial product like a debt or debt like instrument, then, where required, "Rating Subject" should be read as a reference to the Person who was responsible for obtaining the Credit Rating.

In the consultation paper prepared by the DFSA on the rules for Credit Rating Agencies, the DFSA advise that they propose to allow Credit Rating Agencies a maximum period of 6 months to comply with the applicable conduct standards, by way of waivers.

The rules introduced by the DFSA which regulate Credit Rating Agencies are, by and large, consistent with the rules which have been introduced in other jurisdictions. The fact that the DFSA and other regulators saw the need to introduce rules at all, is understandable but unfortunate.