

Working Group on Recommendable Uses of Credit Ratings

Interim Report

June 27, 2011

Japan Securities Dealers Association

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April, 2011
Japan Securities Dealers Association

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in alphabetical order

Working Group on Recommendable Uses of Credit Ratings

Proceedings of Meetings

Session	Date	Agenda
#1	October 12, 2010	1. Purpose and Management of the Working Group 2. Revisions of the Financial Instruments and Exchange Act and related cabinet office ordinances relating to the review of the credit rating system (briefing from FSA)
#2	December 15, 2010	◆ Present condition of credit rating (presentations given by market players) < Credit rating for corporate finance >
#3	February 1, 2011	◆ Present condition of credit rating (presentations given by market players) < Credit rating for structured finance >
#4	April 13, 2011	◆ Present condition of credit rating < Review of previous discussions >
#5	June 22, 2011	◆ Discussions on the interim report of the Working Group on Recommendable Uses of Credit Ratings

Working Group on Recommendable Uses of Credit Ratings

Interim Report

Foreword

Since 2009, the Financial Instruments and Exchange Act of Japan and related cabinet office ordinances have been revised, based on international discussions following the recent worldwide financial crisis, and with a view to correcting investors' overdependence on credit ratings.

Under the revised legislation, the system of registration of credit rating businesses is introduced, and financial instruments business operators are obligated to give explanations when they provide credit ratings offered by unregistered rating firms, and other laws and regulations allowing uses of credit ratings for regulatory purposes (meaning uses of credit ratings under the framework for supervisory oversight) are revised accordingly (for example, the standards applied to lead underwriters for securities issued by their parent entities or subsidiaries are revised).

The Working Group (WG) has been discussing proper and recommendable uses of credit ratings to ensure investor protection. In these discussions, the WG has been verifying and evaluating prevailing uses of credit ratings in Japan, in light of changes in environments surrounding credit rating, and considering whether there will be any other recommendable methods for credit risk evaluations as alternatives for the prevailing credit rating system.

This Interim Report describes the essence of various opinions so far raised and discussed in the WG's meetings in the form of a provisional summary. The WG desires that more detailed discussions on proper and effective uses of credit ratings will be made on the part of market players, based on how the credit rating regulation will take root, how various rules and regulations depending on credit rating will be reviewed or revised, and how the trend of international regulation on credit rating will be changing.

1. Recent History of Debates on Credit Rating

(1) Problems around credit rating

In the wake of the subprime lending crisis coming to the surface in the US since 2007, it was pointed out that structured finance credit ratings have problems about conflicts of interest between issuers and credit rating firms in the stage of making up securitized products incorporating subprime loans as underlying assets. And it was said that the main reason for the likelihood of such conflicts of interest is attributable to the structural mechanism of credit rating where rating firms receive fees from issuers as remuneration for credit rating services. As a consequence, issuers are eager for high credit ratings since they want to sell their financial instruments as much as possible, and credit rating firms expect as much as financial instruments to be created for the purpose of increasing their revenues from rating services. According to the data provided by the US Congress, revenues earned by the three major US-based credit rating firms from rating services for financial instruments incorporating subprime loans were doubled from 2002 to 2007. This shows that issuers created such financial instruments at a very high pace during this period, resulting in revenue increases enjoyed by those rating firms.

While credit rating firms are responsible for establishing and disclosing the rating process capable of obtaining market confidences, it was thought that their self-regulating function didn't work sufficiently because of the remuneration system involving conflicts of interest as explained above. In addition, it is said that most investors may not have been well aware of various problems already under discussion in terms of the adequacy of the rating process or the sufficiency of disclosure of information. Furthermore, the regulating authorities were also users of credit ratings for regulatory purposes (in accordance with the Basel Accord on Capital Adequacy, etc.). It was therefore discussed that all these situations surrounding credit rating might have brought about the recent financial crisis.

(2) International efforts and Japan's response

In April 2008, the Financial Stability Forum (FSF)¹ analyzed the subprime lending crisis through a comprehensive approach and compiled the "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience." In this report, various proposals are made about how the role and uses of credit ratings should be changing. This FSF report was

¹ The Financial Stability Forum (FSF) is a group consisting of financial authorities in countries and territories having significant international financial centers, international financial bodies comprised of financial regulators, and other related entities, with the aim of promoting international financial stability through sharing information about oversight and surveillance of financial markets and strengthening of international cooperation. In April 2009, the FSF was reestablished as the Financial Stability Board (FSB) with an organizational footing more strengthened and expanded.

supported by the G7 summit. Subsequently, the G20 summit was held to discuss finance and world economics and their discussions on credit rating drew global attention.

The International Organization of Securities Commissions (IOSCO)² has also been discussing what credit rating ought to be since the Enron scandal. In the “IOSCO Statement of Principles regarding the Activities of Credit Rating Agencies” published in September 2003, the following four principles were specified: (i) quality and integrity of the rating process, (ii) independence and conflicts of interest, (iii) transparency and timeliness of ratings disclosure, and (iv) confidential information. In December 2004, the “Code of Conduct Fundamentals for Credit Rating Agencies” were published to indicate the detailed guidance to implement these four principles. These Code of Conduct Fundamentals were revised, in the wake of the subprime lending crisis, by virtue of the “Role of Credit Rating Agencies in Structured Finance Markets” published in May 2008. According to the Code of Conduct Fundamentals, credit rating firms are required to comply with their own code of conduct established in line with the Code of Conduct Fundamentals, and they are required to explain reasons or grounds if they don’t follow the Code of Conduct Fundamentals.

In July 2009, IOSCO established a standing committee on credit rating agencies (CRAs), also known as Standing Committee 6 (SC6). In February 2011, the SC6 published the final report, “Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies,” in which the SC6 reviewed CRA supervisory initiatives in Australia, the EU, Japan, Mexico, and the US in order to evaluate whether, and if so how, these regulatory programs implemented the four principles set forth in the 2003 IOSCO paper, Statement of Principles Regarding the Activities of Credit Rating Agencies.

Regarding regulators’ oversight of CRAs, IOSCO decided to revise the “Objectives and Principles of Securities Regulation” in the Annual Conference held in Montreal, Canada in June 2010 to newly incorporate the following principle: “Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.”

At IOSCO, the SC6 is continuing to review internal controls in CRAs and how to control their conflicts of interests, and discuss measures to curb dependence on CRAs in securities

² The International Organization of Securities Commissions (IOSCO) is an international organization consisting of securities regulatory commissions, securities exchanges, etc. in various counties and territories. IOSCO formulates principles, guidelines, and other international rules concerning securities oversight.

business and securities regulation.

In Japan, a report submitted by the Financial System Council to the Financial Services Agency (FSA) in December 2008 recommended the introduction of the CRA registration system based on the IOSCO Code of Conduct Fundamentals. In the wake of this report, a proposed revision to the Financial Instruments and Exchange Act (FIEA) was submitted to the Diet in March 2009 and the revised FIEA was enacted in June 2009. (The revised FIEA was put in force in April 2010, except for the provisions concerning the accountability for using credit ratings offered by unregistered CRAs which were effective from October 2010.)

In the EU, the CRA registration system was introduced under the Regulation of the European Parliament and of the Council on Credit Rating Agencies (promulgated in November 2009). However, the obligation of registration wasn't imposed immediately under this Regulation. Instead, the registration system was introduced in phases and then implemented in full swing from the end of 2010.

In the US where credit rating originated, various discussions had already been made. From the 1970s to 1980s, there was a system of officially recognizing CRAs whereby a qualified firm is recognized by the US Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization (NRSRO). Then, the discussions in the wake of the Enron scandal resulted in the revision of the Securities Exchange Act of 1934 in June 2007, introducing the CRA registration system. Under this system, NRSROs are basically registered with and regulated by the SEC. Subsequently, this system was extensively reviewed and revised by virtue of the Financial Regulatory Reform Act put into law in July 2010 under the Obama administration.

(3) Problems pointed out in relation to credit ratings

From 2004 to 2007, high credit ratings were assigned to residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO) incorporating subprime loans and this trend drove up incredible growth in subprime loans, but after mid-2007, most of such highly rated products were rapidly and drastically downgraded. Given this fact, the FSF report suggested a possibility that credit evaluations by CRAs might be partly responsible for the subprime lending crisis. In the same context, the US Securities and Exchange Commission (SEC) announced a staff report in mid-2008, stating the findings from the SEC inspectors' investigations against the three major US-based CRAs.

In Japan, the Financial Markets Strategy Team established in the Financial Services Agency (FSA) pointed out some problems such as: (i) credit rating methodologies (the credit rating

models and their adequacy), (ii) conflicts of interest (especially pertaining to the remuneration system for securitized products), (iii) information disclosure (appropriate disclosure of the information about the credit rating models adopted and their adequacy).

(4) History of CRAs

In the US, Moody's released a book entitled "Moody's Manual of Investments-Railroad Securities" in relation to railroad networks that were being built and improved in the early 1900s. Since such railroad securities went into default in the ensuing Great Depression, it was recognized that their credit ratings and default rates were correlated with each other and then the importance of credit ratings of corporate bonds started to be recognized. Shortly, the importance of credit ratings took root in the US, and from 1975, credit ratings were used for regulatory purposes in the form of the SEC's accreditation of NRSROs.

When Japan faced the 1930 depression resulting from the worldwide Great Depression, the campaign for recovery of market confidences in corporate bonds was deployed and the principle of collateralization and other approaches were implemented. In Japan, therefore, it took some more time to establish the practice of using credit ratings. After some time, unsecured bonds started to be issued, and from the 1980s, credit ratings started to be used as the issue standards for securities. In this way, the importance of CRAs acting as a third party evaluator became recognized in Japan, too. Then, the issue standards were integrated with the credit rating standards and the system of designating credit rating businesses was launched in 1992. As a result, the issue standards formerly adopted were completely abolished in 1996.

(5) Introduction of credit rating regulation in Japan

The credit rating regulation under the Financial Instruments and Exchange Act (FIEA) as revised in 2009 is primarily intended to ensure CRA's independence from the issuers of financial instruments to be covered by credit ratings and avoid conflicts of interest between them, ensure the quality and integrity of the credit rating process, and ensure the transparency for the benefit of investors and other market players. The provisions concerning this credit rating regulation are roughly classified into the following categories: (i) duty of fairness, (ii) disclosure of information, (iii) establishment of the proper system, and (iv) prohibited acts.

The duty of fairness of (i) means that CRAs are required to perform their rating service as an independent party in a fair and faithful manner. Disclosure of information of (ii) is required in the following two respects: timely disclosure of rating policies (including the policies for assignment of credit ratings and the policies for offering credit ratings) and regular disclosure of briefing documents that must be made available for public inspection. The system to be established by a CRA as shown in (iii) must be capable of quality management and ensuring

of integrity for the rating process and preventing conflicts of interest. As part of the prohibited acts of (iv), CRAs are not allowed to offer credit ratings if they have some interest with issuers of financial instruments.

In Japan, however, whether to be registered or not depends on each CRA's discretion. In case of an unregistered CRA, the credit ratings offered by it are regarded as unregistered ratings. Under this voluntary registration system, if a financial instruments business operator uses unregistered ratings to provide information to investors, they are obligated to explain the reason for such use.

The credit rating regulation comprised of the four major categories of (i) through (iv) mentioned above has been introduced in a way to achieve alignment with the IOSCO Code of Conduct Fundamentals.

(6) Introduction of the regulator's oversight of CRAs in Japan

The requirements for the system that is required to be established by each CRA are specified in the FIEA, mainly by reference to the regulation adopted by the EU. Accordingly, each CRA's system must have the functions to enable quality management of the credit rating process, ensure the independence and fairness, and prevent conflicts of interest. To ensure the independence and fairness, CRAs must regularly implement rotation of personnel such as analysts and rating committee members in order not to cause only certain individuals to continuously work for the credit rating process. If an analyst belonging to a certain CRA transfers to any other enterprise, this CRA must review all of its rating services performed for that enterprise in the past for which this analyst worked, in order to confirm that there are no conflicts of interest.

In the course of assessing the credit rating for a certain financial instrument, the analyst in charge is prohibited from receiving money in the amount exceeding the permitted range or other goods from the issuer of that financial instrument. To ensure timely disclosure, CRAs are required to announce their rating policies (including the policies for assignment of credit ratings and the policies for offering credit ratings).

As part of the policies for assignment of credit ratings to be established and followed by CRAs, the FIEA requires that a CRA should confirm with the issuer in advance whether there is any misinterpretation of facts. Under the EU regulation, it is required to take sufficient time of not less than 12 hours to verify the facts. In Japan, however, such a uniform time requirement is not specified, but a case-to-case approach is adopted. As part of the policies for offering credit rating to be established and followed by CRAs, the FIEA specifies the contents

that must be published by each CRA when a rating assigned by the CRA is published.

(7) Accountability when using unregistered credit ratings

While registered CRAs are obligated to disclose some information under law, this obligation is not imposed on unregistered CRAs, which is likely to make investors unable to understand the meanings of ratings offered by such unregistered CRAs. Therefore, financial instruments business operators must be accountable for using credit ratings offered by unregistered CRAs (unregistered ratings), because they act as intermediary agent in the markets. When providing an unregistered rating to investors, the financial instruments business operator is required to explain the following matters: (i) the fact that it is an unregistered rating, (ii) the significance of the registration of credit rating businesses, (iii) the name, representative, and location of business of the unregistered CRA, (iv) the summary of the policies and methodologies for offering credit ratings adopted by this CRA, and (v) the presumed conditions, significance, and limitations of credit rating.

This accountability of financial instruments business operators is mitigated if an unregistered CRA belongs to a corporate group globally conducting credit rating business and having an affiliated entity registered in Japan, satisfies the prescribed criteria, and obtains the designation by the FSA Commissioner.

The prescribed criteria in this case are as follows: (i) the level of information disclosure is same as the CRA registered in Japan; (ii) common rating policies and methodologies are uniformly adopted across this corporate group; and (iii) such common policies and methodologies are announced through the CRA registered in Japan.

(8) Using credit ratings for regulatory purposes

From the standpoint of preventing overdependence on credit ratings, international discussions are ongoing in a way to abolish uses for credit ratings for regulatory purposes and consider reasonable alternative methods. In any case, a global consensus is that uses of credit ratings for regulatory purposes should be reduced.

According to the FIEA, there are certain matters concerning credit rating that must be stated in securities reports and other offering disclosure documents. Under the revised FIEA, issuers must state, in addition to the rating symbols, the following matters: (i) the contents, presumed conditions, and limitations of the credit ratings and (ii) the issuer's method to obtain the information announced by the CRA based on its policies for offering credit ratings. When it comes to foreign securities, financial instruments business operators are allowed to disclose the information in a simplified form, in lieu of statutory disclosure documents that would

otherwise apply. In case of foreign securities, therefore, the matters concerning credit ratings that are required to be stated do not apply.

The FIEA specifies certain requirements that apply when a financial instruments business operator is appointed as a lead underwriter for securities to be issued by its parent company or subsidiary, etc. After these requirements have been reviewed and revised, the requirement that such securities must be scored by a designated CRA is eliminated and a new requirement is incorporated.

(9) Credit rating regulation in Japan and the US

In the US, there are no rules to restrict the form of organization or the principal place of business of a CRA to be registered with the SEC. And the registration as a whole group is substantially allowed if using the SEC's prescribed form. For example, if a New York-based corporation applies for the registration, its affiliates listed in the form of registration of NRSROs (nationally recognized statistical rating organizations) submitted to the SEC are generally regarded as the registered CRAs in the same way as applied to the New York-based corporation. As a matter of course, the US regulations apply to all these affiliates.

In contrast in Japan, the registration system is operated on an entity-by-entity basis. Consequentially, a credit rating business group based in the US can register only its Japanese affiliate, and other affiliates are regarded as unregistered CRAs in Japan. As explained before, however, insofar as such unregistered affiliates belong to a qualified corporate group as designated by the FSA, the accountability imposed on a financial instruments business operator using any such unregistered affiliate is mitigated to the same level as the registered CRA.

(10) Credit rating regulation in Japan and the EU

Under the Regulation of the European Parliament and of the Council on Credit Rating Agencies (promulgated in November 2009), only CRAs established in the EU region are eligible for registration in the EU. However, if a CRA established outside the EU region satisfies the prescribed criteria, its ratings are available for use in the EU region.

Whether to satisfy the prescribed criteria for a non-EU region is determined through equivalence evaluation. These criteria require, for example, that the credit rating regulations in the non-EU region must be equivalent to those in the EU, and that the credit rating information must be regularly exchanged and shared by this non-EU region's regulator and the EU regulator. Since Japan is determined qualified through this equivalence evaluation, the ratings offered by CRAs established in Japan can be used in the EU region.

2. Credit Rating for Corporate Finance

(1) Using credit ratings

Credit ratings are used as commonly-accepted indicators to evaluate the creditworthiness, and they also serve as indicators for pricing in the primary market and indicators for sale and purchase transactions in the secondary market. In short, credit ratings function as the important market infrastructure.

Since credit ratings are important indicative barometers for market pricing, pricing in the primary market is considered to be based on credit ratings, and pricing in the secondary market is also closely linked to whether a credit rating is high or low. However, when a credit rating is low, market prices range widely, and it cannot be said that the markets depend on credit ratings, but rather, they are conceived as part of important indicators for reference.

When using credit ratings, what should be noted are the following aspects: (i) time span, (ii) static nature, (iii) disclosure of reasoning for credit ratings, and (iv) slow-acting effect. A time span mentioned in (i) needs to be considered, since all securities, regardless of 1-year bonds or 30-year bonds, are indicated by common symbols even though longer-term securities tend to bear a higher default risk. The static nature of credit rating mentioned in (ii) means, among others, that it is difficult to sequentially trace variations in the creditworthiness of enterprises by means of credit ratings. To mitigate this problem arising from the static nature, efforts are made on the part of CRAs; for example, they announce credit ratings, together with short comments such as “stable,” “negative,” etc. to show the outlook for how the current ratings will vary in the future. Regarding the scope of information disclosed about the reasoning for credit ratings mentioned in (iii), it must be noted that the information shown by CRAs is limited to publicly known information only, even though credit ratings have been determined based on the issuers’ undisclosed information.

Looking at investment decisions, it is found that investors encounter the limitations of credit ratings or other factors difficult for them to overcome in various situations. Some investors are forced to make their investment decisions with their limited resources assigned to securities operations, in which event it is considered that they are highly likely to depend more on credit ratings as the basis of decision making. In addition, credit ratings are closely associated with investors’ risk management or compliance with Basel Accord on Capital Adequacy.

(2) Assignment of credit ratings

The roles played by credit ratings in the markets include redressing the information asymmetry and reducing costs of producing information. While the role to redress the information asymmetry is becoming relatively less important as the disclosure system is more enhanced than before, this role still functions to fill the information gap between issuers and investors. In terms of costs of producing information, investors are able to reduce such costs if they use credit ratings, because it is very difficult for investors to study the issuers' creditworthiness for every investment decision. In this sense, CRAs carry an important mission to offer credit ratings capable of being highly trusted by market players. The adequacy of credit ratings is supposed to undergo after-the-fact verification by checking the ratings and defaults. It is therefore very significant that CRAs provide market players with the data showing the correlation between credit ratings and default rates.

What is mainly represented by a credit rating is the comparative rank order of the comprehensive creditworthiness of a debtor or debt. A credit rating assigned to an issuer (debtor) represents its ability to perform the obligation by the due date. And a credit rating assigned to a specific debt is determined based on collectability of pledged collateral, the order of precedence to receive payments, credit enhancing instruments such as guarantees or insurance, and so on. However, a credit rating is merely an opinion expressed by the CRA and does not constitute investment advice through brand recommendation or credit rating.

Outside Japan, even securities rated "speculative" or "high risk" are treated as investment targets in general. In most cases in Japan, however, such securities are considered as if they were not investable, and some investors have investment criteria or in-house rules to restrict investments in speculative-grade securities. In this regard, it is necessary to examine the impact of such in-house rules from time to time, among others, whether or not such rules may excessively disturb investors' own decisions.

Now, let's look at business models for credit rating services. In Japan and many other developed countries, the fee-for-service model is adopted in general wherein rating fees are paid by issuers to CRAs. In the US, some CRAs adopt the subscription fee model wherein subscription fees are collected from users of credit ratings (investors). In the EU, whether it is necessary to newly establish a government-sponsored CRA (governmental and nonprofit service model) is discussed.

The typical business model of CRAs in the initial stage was a subscription fee model. However, in order to respond to various changes in the markets arising in the 1970s, the fee-for-service model was introduced. While it is commonly known that the fee-for-service model

is likely to cause conflicts of interest, it is also necessary to recognize that even the subscription fee model (with fees paid by recipients of information) could involve potential conflicts of interest.

3. Credit Rating for Structured Finance

(1) Product Structuring and credit rating

Corporate finance is a mechanism to provide a credit facility to an enterprise based on risk analysis made for its whole business. Corporate finance is classified into equity finance (issue of shares, etc.) and debt finance (borrowing, issue of corporate bonds, etc.). On the other hand, structured finance is a credit facility provided to an enterprise's specific business segment alone. This scheme enables the enterprise to procure funds based on the specifically defined assets that are simpler than its whole business assets.

Under the commonly-used mechanism to structure securitized products, a special purpose company is used to retain specified assets, and the debts corresponding to those assets are divided into multiple layers to be issued individually as securities. Such debts are classified into senior, mezzanine, and subordinate tranches. When default occurs, the outstanding obligations are supposed to be performed in descending order of tranche ranking. Therefore, credit risks are ranked in the order of senior, mezzanine, and subordinate. What matters to structure a securitized product are the stability of cash flows from underlying assets, the issuer's cash flow transparency, and a mechanism as a financial instrument that the best fits the risk characteristics of the assets to be structured.

If the cumulative sum of losses on a securitized product falls within the range of a cushion including predetermined subordinate tranches and the risk of loss and other factors remain within the scope estimated at the time of securitization throughout the duration, then senior tranches will be fully redeemed. Therefore, if the cumulative sum of losses exceeds the estimated range, default will occur beyond the subordinate tranches, but even in this case, the losses attributable to the senior tranches are limited.

The major steps in the process of designing a securitized product are as follows. First, the arranger or other person sets the targeted credit rating that they want to obtain at the time of securitization. Second, the requirements for satisfying the targeted rating are examined by, for example, confirming the criteria adopted by the CRA. Third, credit enhancing instruments or cash reserves at the levels exceeding the CRA's criteria are arranged, and then a product fit for the market is structured.

If a credit rating is assigned to an enterprise, it is indicated in the form of a variable because the whole business condition of the enterprise is evaluated. As a securitized product is made up based on the targeted credit rating as explained above, the product itself is indicated in the form of a variable. However, some securitized products can be substantially viewed as the issuers themselves. If a product is significantly influenced by the operator, its credit rating may be scored at the level close to the rating assigned to the operator.

Some securitized products involve more complicated scheme. Such a product may be comprised of many small-size tranches divided in a complicated way, or created under a multilayer structure (resecuritization). If a product has many tranches divided in a complicated way, each tranche may be significantly influenced by any change in the underlying assets. One of the typical resecuritized products is comprised of parts separated from multiple securitized products and put into one. Such a resecuritized product may obtain a high credit rate, even though its respective components are not rated so highly. It is very difficult for investors to analyze these kinds of products.

(2) Assignment of credit ratings

When a CRA assesses a credit rating for an expected loss as part of its structured finance rating service, the following secondary attributes are considered: (i) default probability, (ii) risk of high volatility in the rating, (iii) resilience to unexpected events, and (iv) whether there is transparency, information, or material uncertainty.

In terms of the point of (i), a high rating is not assigned to a product if default is expected to surely occur even though the full amount can be collectible. In other words, a product with a high default rate is not scored highly. In terms of the point of (ii), if a product or bond has a risk of being rapidly downgraded (cliff risk), a high rating is not assigned. Regarding the point of (iii), if a product is considered resilient to foreseeable events, it is presumed to withstand unexpected events to a certain extent. This means that, for a product to be highly rated, the risk in case of a material event must be limited. In light of transparency, information, or material uncertainty mentioned in (iv), a product with high volatility (namely, with high uncertainty) is not given a high rating.

It can be said that structured finance credit ratings show the ranking of creditworthiness. While it may be difficult to accurately predict the amounts of futures losses, it is possible to rank the creditworthiness of the products.

Recently, there are moves to provide information to complement structured finance credit ratings, including indicators implying rating volatility and sensitivity analysis. For example,

some CRAs have introduced volatility scores and parameter sensitivity to use them as supplements for structured finance credit ratings, responding to the subprime lending crisis. A volatility score is a score of uncertainty of the presumed conditions and the model that underlie the credit rating. If this score is high, it suggests that the parameters for estimated losses and the adopted model are highly uncertain and that the credit rating is likely to significantly fluctuate. In addition, a product with a high volatility score requires such enhancing instruments for subordinate tranches that are more sufficient than a product with low volatility in rating. In parameter sensitivity, how sensitive the credit rating is to variations in the loss rate, the conditional prepayment rate, and other parameters is analyzed and indicated.

4. Understanding Present Condition around Credit Rating

(1) Using credit ratings

As a result of exchanging opinions in the meetings, the WG has reaffirmed the fact that issuers, market intermediaries, investors, and many other market players are using credit ratings in various scenes.

The situations of such uses are more specifically reported as follows.

- (i) Credit ratings are used as third party evaluations in accordance with users' in-house rules, etc., in order to eliminate arbitrariness in the course of their risk management or use credit ratings as reference data in the course of their own credit evaluation.
- (ii) Based on credit ratings, users set the ceiling for investments in each category of financial instruments.
- (iii) Credit ratings are used as reference data for users' investment decisions.
- (iv) Credit ratings are used as third party opinions to set the minimum standards for investable products.
- (v) Credit ratings are used as reference data for prior examination of financial instruments.

In any situation, however, market players reportedly use credit ratings, not singularly, but as reference information or supplemental information.

Using credit ratings in these ways are found in respect to both corporate finance ratings and structured finance ratings.

(2) Assessment of the credit rating effectiveness

Most WG members recognize the effectiveness of credit ratings, for both corporate finance ratings and structured finance ratings.

The effectiveness of corporate finance credit ratings is recognized for the following reasons: (i) they constitute part of the information for market evaluations by issuers; (ii) they are needed as part of the information to make investment decisions; (iii) they are part of the indicators needed for risk analysis; and (iv) they serve as part of the criteria to judge the adequacy of financial instruments to be sold in the market.

The effectiveness of structured finance credit ratings is recognized for the following reasons: (i) they are common indicators for investment decisions and helpful to make a comparative review of multiple products; (ii) they serve as reference cases to establish the investment standards because their analysis methods, etc. have been made known to market players; and (iii) efforts to make up such products that fit in for the credit rating methods have been promoting the standardization of structured finance products. Given that structured finance ratings require higher expertise in analysis of underlying assets, etc., an additional opinion said that it is necessary to continuously seek measures to improve the transparency of the credit rating process and enhance the reliability of credit ratings in other respects.

5. Impact of Financial Crisis

(1) Impact of the financial crisis in Japan

The WG members share the same view that the direct impact of the recent financial crisis was relatively smaller in Japan than in the US or the EU. The following reasons for this are pointed out: (i) Japan maintained a conservative stance against the risks based on Japan's past experiences; (ii) the total volume of investments in high-risk assets was small in Japan; (iii) the buy-and-hold strategy was much more common in Japan; and (iv) the size of the secondary market was small in Japan. According to another reason pointed out in addition to these four points, subordinate tranches of structured finance products were retained by originators in most cases in Japan, unlike the US where such subordinate tranches were sold off to investors.

However, it seems questionable whether these characteristics found in Japan during the financial crisis are globally appreciated, according to a certain member's comment. For one thing, Japan may possibly have had no choice other than adopting the buy-and-hold strategy just because the size of the secondary market was small, and for another thing, the buy-and-hold stance may have been disturbing the activation of the secondary market in Japan.

Another comment refers to the possibility that Japan also may face the same problems as suffered by the US and the EU in the future if and after Japan's economy recovers and then trading of securitized products becomes active.

(2) Impact of the financial crisis on credit ratings

According to most WG members' view, it seems that especially big problems in this financial crisis occurred in the area of more complicated types of structured finance products, including products made up by resecuritizing other securitized products, because it is difficult to verify the adequacy of credit ratings for such complicated products in all types of structured finance products.

A certain member referred to the problems concerning corporate finance credit ratings. More specifically, this financial crisis seemed to cause actual or potential problems to corporate finance products for enterprises in the IT and other emerging industries for which accumulated data are not so much.

Another member said it is true that some investors largely depended on credit ratings and that such overdependence is now reformed in the context of worldwide credit rating regulation in response to this financial crisis. According to another view, there are some regulation systems that seem excessive from a global perspective and it is therefore necessary to prevent efficient market functions from shrinking or make sure not to impose the burden of extremely complicated operations on market players.

(3) Limitations of credit ratings

The opinion that there are unavoidable limitations on credit ratings is supported by most WG members as a result of the series of discussions in light of the impact of the recent financial crisis. As a credit rating represents the future state based on the historical records, its effectiveness cannot function well when an unexpected event occurs. On the other hand, however, if we attempted to reflect potential impacts of unexpected events in credit ratings, we would be unable to make credit ratings appropriate for normal economic conditions.

The comments raised in this connection are described more specifically as follows.

- (i) A credit rating is a prediction of the future state under normal economic conditions and its effectiveness is very limited when an unexpected event occurs. The same thing can be said about credit examination and investment decisions.
- (ii) If we attempted to reflect potential impacts of unexpected events in credit ratings, we would be unable to make such credit ratings that fit in for normal economic conditions.

- (iii) There are two opposite ideas about what credit rating ought to be: ratings flexibly responding to changing conditions and stable ratings.
- (iv) Corporate finance credit ratings are likely to vary according to various factors (changes in business results or external environments, etc.).
- (v) With respect to structured finance products using new financial techniques or complicated financial instruments, there are not so much data accumulated. Therefore, the conditions presumed for credit rating are based on simulations using hypothetical data, and in consequence, divergence between the simulated scenario and the actual result is highly likely to become large.
- (vi) There is a gap between simplicity represented by a rating symbol and complexity actually arising in the rating process.
- (vii) If a credit rating depends on publicly available information alone, the slow-acting effect of the rating cannot be avoided.
- (viii) Rapid and drastic downgrading of a credit rating could make the situation even worse.

(4) Indicators as alternatives for credit ratings

If alternative indicators that could replace prevailing credit ratings were successfully devised, dependence on such new indicators might arise and could cause the same problems as we are currently challenging with credit ratings. Credit rating is an established method accepted by market players over a long time and this financial crisis has afforded us the opportunity to deepen our understanding of credit rating, especially its limitations. Taking these views into consideration, the WG's major opinion is that it would be more advisable and effective to make efforts to encourage risk analysis and assessment from perspectives other than credit rating in order to complement the credit rating system, rather than to consider devising a mechanism using alternative indicators commonly available to market players. According to one opinion to be noted in this context, if such efforts consequently make the credit rating system more complicated, it might be detrimental to the credit rating effectiveness as is currently seen in its simplicity that enables us to figure out the creditworthiness by plain symbols.

How to properly and effectively use credit ratings, how to offer credit ratings, and other related topics should be continuously discussed in a way to achieve consistency with global regulation and recognize the actual status around credit rating.

6. Sector-Specific Efforts

To address the problems around credit ratings, credit rating providers are required to enhance the accuracy of their ratings and ensure more enhanced disclosure of information, and credit

rating users are required to fully recognize the limitations of credit ratings and use such ratings on their own responsibility based on their additional analysis or evaluations, etc.

(1) Efforts associated with CRAs

(i) Analysis methods for credit rating

The scope and depth of data to be evaluated and reflected in credit ratings was discussed by the WG. While it might be possible to cover various data, most WG members are concerned that such an approach is likely to make it more difficult for investors to understand credit ratings, or undermine the credit rating effectiveness characterized by plain symbols. According to an additional opinion, it might be more conducive to the stabilization of markets to promote understanding of basic concepts about credit ratings, rather than to expand the scope of data to be evaluated and reflected in credit ratings.

(ii) Scope to be evaluated and reflected in in credit ratings

The WG discussed to what extent exogenous changes must be considered when deciding a credit rating. Foreseeable changes (events) can be incorporated in a credit rating when it is assigned, but if an event that is obviously unforeseeable occurs, the rating may fall behind such an event. On the other hand, if unforeseeable events are evaluated and reflected in credit ratings, it will become impossible to offer such credit ratings that fit in for normal economic conditions.

(iii) How to indicate credit ratings

One opinion suggested that a credit rating be indicated with a range of certain values, instead of a simple numerical score, if we want to reflect both macro and micro factors in the credit rating. However, this opinion was opposed by a concern that such indication might undermine the simplicity achieved by using plain symbols, as well as by a view that the expected results is that investors might just use the lower limit of the given range for their investment decisions. Another comment pointed out that the concept of ranges has already been adopted in the prevailing rating system in the form of outlooks disclosed by CRAs, credit watch, and so on.

(iv) Business models for credit rating service

There are two business models for credit rating services: the fee-for-service structure wherein remunerations are received from issuers in the form of rating commissions and the subscription fee structure wherein remunerations are received from investors in the form of subscription fees. Under the former model, credit ratings tend to be scored in favor of issuers, and under the latter model, credit ratings may possibly be too conservative.

According to one suggestion proposed based on the foregoing views, we should probably examine the idea to replace the prevailing structure in Japan with the structure to receive fees from investors. According to a concern expressed in response to this suggestion, if this new structure is adopted, the following two adverse effects are likely to arise, which must be carefully examined. First, enterprises with self-contained in-house survey teams (such as major banks and investment management firms) will not use external firms' ratings, and this may undermine pricing functions on the markets (leading to higher pricing volatility for issuers). Second, a check-and-balance function involving third party CRAs (leading to the standardization of financial instruments) may not sufficiently work in the course of making up a structured finance product, which would otherwise work through communications between issuers and arrangers, with an eye on ratings to be assigned by CRAs.

Some more opinions follow. In order to make CRAs serve as third party evaluators, it might be necessary to consider the balance between the method of receiving fees from issuers and the method of receiving fees from investors. When making up a repackaged bond incorporating a straight bond (industrial bond), the issuer of this straight bond may sometimes request a CRA to assign a credit rating to the repackaged bond even though this issuer is not directly associated with the process of repackaging. In light of such circumstances, it may be possible to adopt the model of receiving some fees from financial instruments arrangers.

(2) Efforts associated with investors

According to the view reaffirmed by the WG, investors using credit ratings must fully recognize the limitations of credit ratings and consider credit ratings merely as part of reference information, and it is important for investors to carry out their own analysis or evaluations, etc., in addition to the information provided by CRAs, to use credit ratings on the investors' own responsibility.

In terms of Japanese legislation, it is considered that the environment to facilitate investors' understanding of the limitations of credit ratings and other points is being gradually improved, since the laws now require disclosure of information by CRAs, accountability of financial instruments business operators acting as intermediaries in the markets, and other actions to be taken.

(3) Efforts associated with issuers

In the WG's major opinion, corporate finance credit ratings are already subject to the rules prescribed by law, including the duty of disclosure of information imposed on issuers, and structured finance credit ratings are now regulated on some level under the newly established

framework, which requires the confirmation of the status of operators and originates in the course of making up securitized products.

Conclusion (Recommended Uses of Credit Ratings)

The recent financial crisis triggered the establishment and reinforcement of the credit rating regulation across the world. In Japan also, the credit rating system has been reviewed and enhanced in such ways as introducing the CRA registration system. The need for such new regulation has been commonly recognized by many people. At the same time, the new regulation that has just launched requires ongoing review to see whether and how this system will take root and function effectively.

As our future challenges, it is essential to continue various considerations and examinations to redefine what credit rating ought to be in order that they will be properly scored, offered, and used. In this regard, it is desired to take into consideration consistency with the globally adopted rules as well as the points listed below, and design and develop the environments according to the characteristics and risks of respective types of financial instruments so as to encourage credit rating users to make their investment decisions on their own responsibility, without letting only specific persons to determine or restrict how or when to use credit ratings.

- (i) Credit rating users (such as investors) must fully understand the significance and limitations of credit ratings and need to carry out additional analysis or evaluations on their part, independent from CRA's rating information.
- (ii) Credit rating providers (CRAs) must enhance their disclosure of rating information and make the disclosed information easy to understand, in order to help credit rating users carry out their own analysis or evaluations. In addition, credit rating providers must endeavor to make their ratings more proper and accurate.
- (iii) Financial instruments business operators are required to take steps to encourage investors to fully understand the limitations of credit ratings and other matters, prevent investors' overdependence on credit ratings, and ensure the principle of self-responsibility. Of course, financial instruments business operators themselves must also recognize the limitations of credit ratings and carry out their own analysis or evaluations, independent from CRAs' rating information.