

STANDARD & POOR'S
WRITTEN EVIDENCE TO TREASURY COMMITTEE
DATED 7 NOVEMBER 2007

1. Executive Summary

- 1.1 Standard & Poor's Rating Services ("S&P") submits this memorandum in response to the Treasury Committee's request for written evidence on the role and regulation of credit rating agencies. We understand that the Treasury Committee has also asked S&P to give evidence on Northern Rock. Representatives of S&P will attend at the hearing on 13 November to provide oral evidence on these topics. In the meantime, we refer the Committee to the most relevant of the public statements we have made concerning Northern Rock from 2005 onwards, which are listed in the appendix to this memorandum.
- 1.2 In section 3 we provide a description of our credit ratings and explain what they are intended to represent. We explain in particular that such ratings address the likelihood of default of securities, not their marketability.
- 1.3 In section 4 we provide some background on our ratings of residential mortgage-backed securities ("RMBS") and summarise the actions that we took from early 2006 onwards, in response to our concerns over the deteriorating quality of RMBS transactions.
- 1.4 S&P at section 5 underlines its commitment to learning lessons from recent events. We have enhanced our procedures and we are engaged in an active dialogue with numerous market participants so that we can determine what further steps we should take.
- 1.5 Section 6 deals with regulation. S&P has replaced its prior Code of Practices and Procedures with a new Code of Conduct which represents further alignment of its policies and procedures with the Code of Conduct Fundamentals for Credit Rating Agencies published by the International Organisation of Securities Commissions ("IOSCO"). We discuss our adherence to those standards annually with the Committee of European Securities Regulators ("CESR") which reports on credit rating agencies' code implementation and compliance to the European Commission.

2. Standard & Poor's

- 2.1 S&P is a business unit of Standard & Poor's, itself a division of The McGraw-Hill Companies, Inc, ("*McGraw-Hill*"), a global business services provider in the fields of financial services, education and business information. Standard & Poor's has roots going back to 1860. Standard & Poor's was created in 1941, when Standard Statistics merged with Poor's Publishing Company. Standard & Poor's currently employs approximately 8,500 employees worldwide, of which approximately 1,000 employees are based in Europe. Standard & Poor's has been a division of McGraw-Hill since 1966.
- 2.2 The business of Standard & Poor's is to provide financial market intelligence. It is perhaps best known as one of the world's leading providers of independent credit ratings. Standard & Poor's also maintains a wide variety of tradeable and benchmark index

products and services (such as the S&P Global 1200 index) and provides mutual fund analysis and independent equity research.

- 2.3 Standard & Poor's has been engaged in issuing credit ratings since 1916. The total amount of outstanding debt rated by S&P globally is approximately US\$34 trillion in 100 countries. S&P rates and monitors developments pertaining to these issuers from its operations in more than 21 cities in 16 countries around the world.
- 2.4 Standard & Poor's has had an operation in London since 1984. Approximately 650 employees are based in London, which is Standard & Poor's largest base in Europe.

3. **S&P's Credit Ratings**

- 3.1 A credit rating is an opinion that we publish on the creditworthiness of particular issuers or financial obligations. In order to understand our role, it is important to recognise that our opinions relate solely to creditworthiness, by which we mean the likelihood that a particular obligor or financial obligation will pay, on time, the principal amount of the debt and interest owed.
- 3.2 Our ratings do not constitute recommendations as to whether investors should "*buy*", "*sell*" or "*hold*" rated securities, nor do they consider the suitability of securities for particular investors or groups of investors. Similarly, our ratings do not address the likely market performance of an investment or whether its price can be said to reflect its credit risk and/or its expected returns. At their core, our ratings speak only to the likelihood of timely repayment. They are not designed to address other market factors, such as supply and demand, that may affect the pricing of securities.
- 3.3 Our ratings are based on the facts available to us at the time opinions are formed. They are designed to be stable and, unlike market prices, they do not fluctuate on the basis of market sentiment. Nevertheless, it has always been the case that credit ratings, including high "*investment grade*" ratings, can and do change. After a rating has been issued, S&P reviews developments that might alter the initial rating, known as the "*surveillance process*". A rating may be upgraded or downgraded as a result of adjustments to the risk profile of an obligor or security, or because of the emergence of new information. We do not downgrade securities in response to market sentiment; we make adjustments to our ratings when the facts demonstrate the need to make adjustments and not before.
- 3.4 Our ratings range from the highest category of AAA, through AA, A, BBB (which is the lowest of what are referred to as to the "*investment grade*" ratings) to D (indicating a situation where an obligation is in default). Ratings for AA to CCC may be modified by the addition of a plus (+) or minus (-) to show relative standing within the major rating categories. Our highest rating of AAA denotes that, in our opinion, an issuer or security has an extremely strong capacity to meet its financial commitments. Nevertheless, this rating, in common with our other ratings, is not intended to act as an assurance that there is no possibility of default. Instead, our respective ratings are designed to show the relative probabilities of default, so that the risk increases as the rating lowers.
- 3.5 Transition studies of our historical ratings demonstrate a strong correlation between our various rating categories and the rates of default that have actually occurred. For

example, for the period from 1978 to 2006, the weighted average five-year default rate for investment grade structured securities rated by S&P is less than 1%, while for speculative grade securities it is slightly over 15%. By comparison, over a comparable period (1981 to 2006), the weighted average five-year default rate for investment grade corporate issuers is 1.19% and for speculative grade issuers it is 18.07%.

3.6 The following table illustrates, as of 28 October 2007, the cumulative five-year default rate for the initial RMBS ratings that we have issued over a 30 year period.

Initial Rating	% of Default
AAA	0.04
AA	0.24
A	0.36
BBB	1.30
BB	2.89
B	3.48

3.7 Public ratings are made available in real time. When a public rating is assigned or changed, the announcement is made on our publicly available website and a press release may also be provided to news outlets and other media. Currently there are approximately 9 million current and historical ratings available on RatingsDirect, which is a subscription-based product. In addition, there are as many as 1.3 million active ratings available for free on our publicly available website: www.sandp.com.

4. **S&P's Ratings for Residential Mortgage-Backed Securities**

4.1 S&P has been rating RMBS for approximately 30 years and has developed specific processes and models for evaluating the creditworthiness of these transactions. Our track record of assessing RMBS credit quality has been strong as can be seen from the table at 3.6 above.

4.2 When rating RMBS, S&P uses default and cashflow models specially designed for the purpose and made commercially available to the public. With the assistance of these models, S&P rates RMBS by analysing creditworthiness and cash flow aspects of the structure. These models are regularly amended and enhanced over time and those modifications are also made commercially available. S&P also reviews the practices, policies and procedures of originators and servicers as well as the legal documents of the securities to be listed.

4.3 In response to deteriorating sub-prime performance, S&P has adjusted its criteria and assumptions to increase its credit enhancement requirements for certain transactions, having identified certain sub-prime loans as being more likely to default than others. S&P has also heightened the stress levels at which it rates and surveils transactions to account for deteriorating performance as evidenced by data which it has received and has increased the frequency of its review of rated transactions.

- 4.4 At the same time as we were modifying our models to reflect our observations about the sub-prime market, during the period from early 2006 onwards, we issued a series of publications in which we repeatedly and consistently warned the market of our concerns about the deteriorating quality of RMBS transactions. Furthermore, we also took rating actions where appropriate in response to sub-prime deterioration.
- 4.5 In July and October 2007 S&P again took steps in the light of increasingly poor performance data. This included increasing the severity of the surveillance assumptions we used to evaluate the ongoing creditworthiness for RMBS transactions and downgrading those that did not meet these stress test scenarios within given time-frames. We will continue to take rating actions, as appropriate, to reflect the continuing evolution of the position and our assessment of the RMBS market.
- 4.6 What has happened in the sub-prime market and the US housing market generally has been more severe and more precipitous than anyone had anticipated. Furthermore, recent sub-prime transactions have been performing significantly worse than transactions from earlier periods, even for transactions sharing similar underlying characteristics. Delinquencies and defaults in the sub-prime mortgage market have increased significantly. This has been ascribed to a number of factors, including in particular stretched underwriting standards, possible fraud in the origination process, sharply rising interest rates and an unexpectedly steep drop in house prices in the US. In addition to these underlying factors, other new trends have occurred. For example, individuals who purchase homes have historically paid their mortgages before paying off their credit cards, but that now appears no longer to be true to the extent that it once was. Similarly, individuals who live in the homes that they purchase have historically repaid the mortgages on those homes more readily than those who live elsewhere, but this long-standing pattern also now appears to be changing.
- 4.7 S&P regards factors such as these as significant changes of behaviour, particularly at a time of substantial falls in property prices. It was these factors and trends, among others, that led S&P to downgrade some of its RMBS ratings, even though there had been no substantial losses on the pools of assets that back the sub-prime RMBS.
- 4.8 It is important however to put these developments in context. While the "*credit crunch*" was serious, the fact is that the market has not to date witnessed widespread defaults of mortgage-backed securities.

5. **Lessons Learned**

- 5.1 S&P is committed to learning lessons from the events that have led to the recent turmoil in the credit markets, including any lessons on the role and responsibilities of credit rating agencies.
- 5.2 S&P is taking steps to ensure that its ratings - and the assumptions that underlie them - are analytically sound in the light of changing circumstances. For example, as indicated above, we have significantly heightened the stress levels which we use in our analytical models and increased the frequency of our reviews of rated transactions. We have also undertaken a survey of originators and their practices, particularly in relation to data integrity and the ability to detect and manage fraud in the origination process. In sum,

we are continually reviewing our models and processes in order to consider what further changes may be appropriate.

- 5.3 S&P is also maintaining a dialogue with market participants and other interested parties in an effort to determine the steps that the credit rating agencies and others should take in response to recent events. To this end, we are actively engaging in a number of different fora. We are also holding ongoing discussions with regulators and other policy-makers on the role of credit rating agencies and their treatment of structured products.
- 5.4 In this context, we have noted with interest the comment made by the Bank of England's Financial Stability Report about the role of credit rating agencies and its suggestions aimed at facilitating a more sophisticated use of ratings by investors (Issue No. 22, October 2007). We are giving careful consideration to those suggestions.

6. **The Regulation of Credit Rating Agencies**

- 6.1 The issue of the regulation of credit rating agencies was recently reviewed by the European Commission ("*the Commission*"), which published its conclusions in March 2006. The Commission noted that there were already three Directives in place that are relevant to the position of credit rating agencies¹ and concluded that no new legislative initiatives were needed. In reaching this conclusion, the Commission noted that in December 2004 IOSCO had developed a Code of Conduct for credit rating agencies and that many agencies had set up their own Codes of Conduct along the lines of the IOSCO Code.
- 6.2 The Commission concluded that this was an encouraging development, provided that the credit rating agencies implemented their Codes of Conduct in practice, on a day-to-day basis. It therefore asked CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis.
- 6.3 In October 2005, S&P replaced its prior Code of Practice and Procedures with a new Code of Conduct in order to align further its policies and procedures with the IOSCO Code. S&P and certain other credit rating agencies have also agreed to adhere to the following framework for monitoring compliance with the IOSCO Code:
- (a) each agency sends an annual letter to CESR (which is made public) outlining how it has complied with the IOSCO Code and explaining any deviations from the Code;
 - (b) CESR holds an annual meeting with each agency to discuss any issues related to its implementation of the IOSCO Code; and
 - (c) each agency provides an explanation to the national CESR member where any substantial incident occurs with a particular issue in its market.

¹ These Directives are the Market Abuse Directive, the Capital Requirements Directive and the Markets in Financial Instruments Directive.

- 6.4 The framework established by this agreement is already in place, and in December 2006 CESR published its first report to the Commission on the compliance of credit rating agencies with the IOSCO Code (S&P subsequently revised its Code in response to CESR's comments). S&P and other credit rating agencies are continuing to participate in this framework and CESR is due to publish its next annual report by mid-May 2008.
- 6.5 The framework established by IOSCO, the Commission and CESR is a relatively new one, but one that S&P believes provides an effective, flexible and transparent mechanism for ensuring that credit rating agencies comply with a clearly defined and comprehensive set of external standards.

Appendix

S&P publications on Northern Rock

Listed below are the most relevant publications from 2005 to date:

Date	Description
12 October 2005	Change from A (stable outlook) to A (positive outlook).
1 August 2006	Upgrade from A to A+ (stable outlook).
27 June 2007	Change from stable to negative outlook in light of profit warning.
14 September 2007	Downgrade to A (negative outlook).
19 September 2007	Downgrade to A- (negative outlook).
26 September 2007	Placed on CreditWatch with developing implications.