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Dear Chair of the Board,

Dear CEO,

Thematic findings on the effectiveness of governance in credit rating agencies

We are sending this letter to all UK registered credit rating agencies (CRAs). We expect you to consider the risks outlined and act where necessary.

In February 2022, we sent a letter to the credit rating agency portfolio outlining our view of risks in the areas of ratings process and methodologies, governance and oversight, market and perimeter risks, and operational resilience and resourcing. We stated our view that sound governance, both its effectiveness and design, is at the heart of producing high quality ratings.

Since then and as part of our ongoing review of governance as a key driver of culture, we have reviewed the Board structures and Board documentation of all the registered CRAs within the portfolio. Further, for a selection of CRAs, we have met with Board members, which included senior executives and independent non-executive directors (INEDs) and observed Board meetings. We believe that governance goes beyond formal governance at the Board and in the most senior levels of leadership. We also look to the broader set of processes, systems, controls and arrangements by which decisions are made. This letter provides feedback on common findings from these reviews and our wider supervisory work across the portfolio.

Overall, it was clear that multiple CRAs can do more to benefit from the value that a well-functioning Board can bring to the strategic direction and oversight of an organisation. This issue is heightened by the global nature of many CRAs, which often leads to an inadequate level of consideration and control given to the UK Board. We think that strong Board governance, clear Board-level accountability and independent challenge are essential to ensure your organisations deliver independent ratings free from conflicts of interest. We think there are gaps in this respect at some CRAs.

We expect you, your senior leadership and your Boards to consider the risks outlined below with regards to your business, how you monitor these risks and whether you have appropriate strategies in place to address them.

Purpose of the Board

We supervise UK CRAs according to Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies amended by the SI

2019/266 The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 (referred to collectively as the 'CRA Regulation'). Annex I, Section A, paragraph 1 of the CRA Regulation outlines the requirements and overall responsibility of the Board. We expect firms to meet the CRA Regulation both in principle and practice. This means that the Board should ensure meaningful oversight of the independence of UK credit rating activities, management of conflicts of interest and compliance with the CRA Regulation.

We consider that an effective Board plays a key role in overseeing and holding to account senior management. With respect to company culture, the Board can promote setting the tone for a relationship with the regulator which we expect to be open, transparent and proactive. Many CRAs operate as part of global structures, and we expect the UK Board to have a clear role and purpose in overseeing the credit rating activities of UK regulated entities. This encompasses the firm’s strategy as well as its operational performance.

We are concerned that the UK Board may play a diminished role where this is a global group structure as more focus may be given to the parent Board. We expect the UK Board to meet the requirements of the CRA Regulation not just on paper, and to operate with a clear purpose and understanding of the UK market. We saw instances where senior management considered the meeting of the UK Board as a regulatory formality. This was reflected in lack of senior management participation in Board meetings, information requests of INEDs not being addressed and decision-making related to UK credit rating activities being taken without knowledge or consent of the UK Board. You should assess the role of the UK Board, the responsibility it is given and where lacking, make any necessary adjustments to give it appropriate and meaningful control of UK activities.

Composition of the Board

The CRA Regulation states that at least one third, but no less than two, of the members of the Board shall be independent members who are not involved in credit rating activities. Further, for CRAs which issue credit ratings on securitisation instruments, at least one INED and one other member of the Board should have in-depth knowledge and experience on structured finance. Overall, senior management on the Board should ensure the sound and prudent management of the CRA.

A well performing Board consists of individuals with a diverse mix of skills, experience and industry knowledge, relative to the needs of the business. We expect Board members to be capable of providing input on the strategy of the firm and key risks associated with the delivery of independent ratings. This includes management of conflicts of interest, internal quality controls, and processes for compliance and governance. When the risks facing the firm are well understood by the Board, this leads to better oversight. Where the Chair is also the Chief Executive, extra care is required to maintain a division of roles and objectivity, and to ensure open discussion and active encouragement to share views.

We saw failures to meet the basic Board composition requirements for the number of INEDs. Further, while there is no requirement in the CRA Regulation on the number of directors to serve on the Board (aside from the requirement for at least two INEDs), membership should take into account the range of skills necessary to operate a CRA and succession planning – too few directors may lead to gaps in skills. Further, an imbalance in the ratio of executives to non-executives may compromise the role of the independent members. We noticed inconsistencies in Board members’ understandings of the key risks of a CRA which may imply absence of a risk framework, inadequate Board level discussions and/or insufficient knowledge at Board level. You should assess your Board structure and skills to ensure that your Board has sufficient expertise to conduct its responsibilities.

Role of the INEDs

The role of the INED is to provide independent oversight and challenge. Further, INEDs for CRA Boards have the specific task of monitoring the development of credit rating policy and methodologies but should not be involved in credit rating activities.

To deliver on the above, we expect INEDs to be professionally selected through a robust process, have the range of skills required to oversee the CRA and undergo a thorough induction process that provides access to individuals across the organisation. INEDs should demonstrate an understanding of their responsibility and their remit, which involves achieving an appropriate balance in their involvement with the business.

We saw that some CRAs are not taking the necessary steps to maintain independence of the INEDs. This may be through a lack of an objective recruitment process or INEDs potentially being involved in credit rating activities. We welcome that certain CRAs have gone above the minimum requirements of the CRA Regulation for INED representation on the Board. We recognise this as a strength, which will help to ensure a smooth succession when the mandatory five-year mandate expires. We saw varying levels of INED challenge at Board meetings and, where challenge is made, differing degrees of acceptance by senior management to address issues and requests for information. You should review your INED recruitment process for objectivity and your induction process for continuity. You should identify the appropriate INED skills and background for your business and validate whether the current INEDs are able to assess the key risks to your CRA. Your senior management should consider their responsiveness to challenge by INEDs and monitor how you address any issues raised.

How the Board operates

How a Board operates will affect its overall effectiveness. We consider multiple aspects including Board member behaviour, Board meetings and information flow to the Board.

We expect the relationship between Board members to be challenging and supportive during and between Board meetings. Board meetings should be held with appropriate frequency, be of an appropriate length to enable proper consideration of issues and conducted in an open manner that supports critical thinking and discussion of difficult issues. To deliver on this, information flow to Board members should be timely and of sufficient clarity and detail to facilitate informed discussion and decisions. There should be adequate follow up on matters raised, evidenced in accurate and detailed minutes.

We saw differing levels of consideration at Board meetings ranging from in-depth to superficial. We saw instances where Board members participated fully and actively but in others, we saw members leaving meetings before the conclusion of material discussions. While Board meeting papers for certain firms were comprehensive in nature with transparent documentation of next steps, others failed to present key details or did not reflect the reality of the business. We saw instances where the use of data, key risk indicators, and management information systems to monitor risks were not apparent or inadequate. If you fall short in any of these areas, you will need to take the necessary steps to address the shortfalls.

Next steps

Given the importance of governance in ensuring the quality of ratings and methodologies, we expect all CRAs to consider the findings in this letter and any work they may need to do to rectify any issues. We expect firms' action plans to be strategic, appropriately resourced, and address the root causes of those issues.

We request you provide us with a Board-approved summary of your firm's assessment of key risks relating to governance and details of action plans including timescales by 30 January 2023. You should also identify the member of your senior management team who will oversee the provision of this and the implementation of its action plans and notify us of this contact person by 11 November 2022.

As part of our ongoing supervisory focus on governance and oversight, we will continue to engage with you and your Board. Where individual firms fall short of our expectations, fail to consider our feedback or are making insufficient progress, we will consider the full range of supervisory responses and enforcement powers at our disposal.

Please send your summary assessment to Creditratingagencies@fca.org.uk. If you have any questions, please contact your FCA supervision team. We will review these responses and consider appropriate next steps.

Yours faithfully

Edwin Schooling Latter

Director of Infrastructure & Exchanges
Financial Conduct Authority