Credit rating agencies

2008/0217(COD) - 12/11/2008 - Legislative proposal

PURPOSE: regulation of the Credit Rating Agencies.

PROPOSED ACT: Regulation of the European Parliament and of the Council.

CONTENT: credit rating agencies active in the EU are mainly governed by the International Organisation of Securities Commissions (IOSCO) code of conduct, which is based on voluntary compliance, and are subject to a yearly assessment by the Committee of European Securities Regulators (CESR). It is commonly agreed that credit rating agencies contributed significantly to recent market turmoil by underestimating the credit risk of structured credit products. The great majority of subprime products were given the highest ratings, thereby clearly underestimating the major risks inherent in those instruments. Furthermore, when market conditions worsened, the agencies failed to adapt the ratings promptly.

The current crisis has revealed weaknesses in the methods and models used by credit rating agencies. One reason may be that credit rating agencies operate in an oligopolistic market that offers limited incentives to compete on the quality of the ratings produced. The poor quality of ratings of structured finance instruments has considerably contributed to the current crisis. In addition, shortcomings in the agencies' communication with users of credit ratings became evident. As a result, market participants' confidence in the performance of credit rating agencies and in the reliability of ratings has suffered. Self-regulation based on voluntary compliance with the IOSCO code does not appear to offer an adequate, reliable solution to the structural deficiencies of the business.

In the US, where most of the credit rating agencies with significant EU activities have their parent companies, credit rating agencies have been subject to regulation and supervision since summer 200710. Given the global nature of the rating business, it is important to level the

playing field between the EU and the US by setting up a regulatory framework in the EU comparable to that applied in the US and based on the same principles. In the light of these considerations, this proposal for a regulation has **four overall objectives**aiming at improving the process of issuance of credit ratings:

1) to ensure that credit rating agencies avoid conflicts of interest in the rating process or at least manage them adequately;

2) to improve the quality of the methodologies used by credit rating agencies and the quality of ratings;

3) to increase transparency by setting disclosure obligations for credit rating agencies;

4) to ensure an efficient registration and surveillance framework, avoiding 'forum shopping' and regulatory arbitrage between EU jurisdictions.

The Commission intends to develop the regulatory framework for the issuance of credit ratings in order to ensure a high level of investor confidence and consumer protection.

This proposal is part of a package of proposals to deal with the financial crisis and adds to Commission's proposals on Solvency II, Capital Requirements Directive, Deposit Guarantee Schemes and accounting. The new rules are designed to ensure high quality credit ratings which are not tainted by the conflicts of interest which are inherent to the ratings business.

The proposal lays down **conditions for the issuance of credit ratings** which are needed to restore market confidence and increase investor protection. It introduces a registration procedure for credit rating agencies to enable European supervisors to control the activities of rating agencies whose ratings are used by credit institutions, investment firms, insurance, assurance and reinsurance undertakings, collective investment schemes and pension funds within the Community.

Credit rating agencies will have to comply with rigorous rules to make sure (i) that ratings are not affected by conflicts of interest, (ii) that credit rating agencies remain vigilant on the quality of the rating methodology and the ratings and (iii) that credit rating agencies act in a transparent manner. The proposal also includes an effective surveillance regime whereby European regulators will supervise credit rating agencies.

New rules include the following:

- credit rating agencies may not provide advisory services
- they will not be allowed to rate financial instruments if they do not have sufficient quality information to base their ratings on
- they must disclose the models, methodologies and key assumptions on which they base their ratings
- they will be obliged to publish an annual transparency report
- they will have to create an internal function to review the quality of their ratings
- they should have at least three independent directors on their boards whose remuneration cannot depend on the business performance of the rating agency. They will be appointed for a single term of office which can be no longer than five years. They can only be dismissed in case of professional misconduct. At least one of them should be an expert in securitization and structured finance.

Some of the proposed rules are based on the standards set in the International Organisation of Securities Commissions (IOSCO) code. The proposal gives those rules a legally binding character. Also, in those cases where the IOSCO standards are not sufficient to restore market confidence and ensure investor protection the Commission has proposed stricter rules.