

# Credit rating agencies: future perspectives

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The European Parliament adopted a resolution on credit rating agencies (CRAs): future perspectives.

The resolution recalls that CRAs are supposed to be information intermediaries, reducing information asymmetries in the capital markets and facilitating global market access.

In recent legislation, CRAs have been assigned another role which can be classified as one of 'certification', reflecting the fact that ratings are increasingly embedded in regulatory capital requirements. CRAs played a significant role in the build-up to the financial crisis through the assignment of faulty ratings to structured finance instruments. The credit rating industry has various problems, amongst which the most important are the lack of competition, oligolistic structures and the lack of accountability and transparency. A problem of the dominant rating agencies in particular is the payment model and whereas the regulatory system's key problem is over-reliance on external credit ratings.

Firstly, the report assesses the macroeconomic role of CRA in the global financial market regulation and then looking at the intermediate level and questions of competition and the industry structure. Lastly, the report assesses conflicts of interest in the business model, i.e. the micro level.

## (1) Macro level: financial market regulation

**Over-reliance:** Parliament considers that the over-reliance of the global financial regulatory system on external credit ratings has to be reduced as far as possible and in a realistic timeframe. It considers it important to establish a capital adequacy framework that ensures robust internal risk assessment, better oversight of such risk assessment, and improved access to credit-relevant information. Members support in this respect the increased use of the **internal-ratings-based (IRB) approach** provided that it is reliable and safe and that the size, capacity and sophistication of the financial institution allow for an adequate risk assessment.

Parliament expresses the view that market participants should not invest in structured or other products if they cannot assess the underlying credit risk themselves, or alternatively that they should apply the highest risk weighting.

**Increased capacity for supervisors:** Members are aware of the inherent conflict of interest if market participants devise internal credit risk assessments for their own regulatory capital requirements. Hence, they see the need to increase supervisors' responsibilities, capacity, powers and resources for monitoring, assessing and overseeing the adequacy of the internal models and for imposing prudential measures. They consider that if an internal model cannot be appropriately assessed by the supervisor due to its complexity such a model shall not be approved for regulatory use.

## (2) Intermediate level: industry structure

**European Credit Rating Foundation:** the Commission is asked to conduct a detailed impact assessment and viability study on the costs, benefits and potential governance structure of a fully independent European Credit Rating Foundation (ECRaF) which would expand its expertise into all three sectors of ratings. The Commission should consider the start-up financing costs to cover the first three to maximum five years of the Foundation's work. Members are strongly of the opinion that financing costs should under no circumstances be borne by taxpayers and considers that no further funding should be provided and that the new ECRaF should be fully self-sufficient financing its own budget after the start-up period.

Members consider that, to ensure its credibility, the management, staff and governance structure of the new Foundation need to be **fully independent and autonomous**. i.e. not bound by instructions vis-à-vis the Member States, the Commission and all other public bodies as well as the finance industry and other CRAs.

**Disclosure and access to information:** Parliament points out that, in order to enable investors to adequately assess risk and to fulfil their due diligence and fiduciary duties, increased disclosure of information on products is necessary in the field of structured finance instruments to allow investors to make informed judgments. Sophisticated investors should be able to assess the underlying credits from which they can then derive the risk of a securitised product. The resolution calls on the Commission to assess the **need to increase disclosure of information for all products in the field of financial instruments**. It also calls on the Commission to propose a revision of Directive 2003/71/EC and Directive 2004/109/EC in order to ensure that sufficient accurate and complete information on structured finance instruments is more widely available.

Members call for, alongside increased transparency of the rating process and its internal auditing, **stronger supervision** of CRAs by EU supervisory authorities and of more intrusive supervision by national supervisory authorities of the use/dependency on ratings by financial institutions.

**Two obligatory ratings:** Members consider that the Commission should consider whether, under certain circumstances, the use of two obligatory ratings is appropriate e.g. for structured finance instruments and for any external credit ratings used for regulatory purposes and whether the most conservative, meaning least favourable, external credit rating should be regarded as the reference for regulatory purpose.

**Sovereign debt rating:** Members ask the industry to **clarify which methodology** and judgments are used to calibrate sovereign ratings and to explain deviation from these model-generated ratings and from the forecasts of the main international financial institutions.

Given the effects that credit ratings of sovereign debt can have on the market, Members support enhanced disclosure and explanation of methodologies, models and key rating assumptions adopted by credit rating agencies.

### **(3) Micro level: business model**

**Payment models:** Parliament supports the existence of various payment models in the industry but highlights the existence of risks of conflicts of interest which need to be addressed by appropriate transparency and regulatory means while not imposing an unwarranted model. The Commission is asked, based on the recent consultation, to come forward with proposals for **alternative viable payment models** that involve both issuers and users.

Members take the view that good governance in CRAs is crucial to ensure the quality of ratings and calls for full transparency from CRAs on the governance arrangements in place.

**Accountability, responsibility and liability:** Members consider that CRAs should be held accountable for the consistent application of the underlying methodology of their credit ratings. They recommend therefore that CRAs' exposure to civil liability in the event of gross negligence or misconduct be defined on a consistent basis across the EU and that the Commission should identify ways for such civil liability to be anchored in Member States' civil law.

The resolution suggests that each registered CRA should conduct an annual review to assess its past credit rating performance and should compile this information in an accountability report for the supervisor. It suggests that the [European Securities and Markets Authority](#) (ESMA) should carry out random checks on accountability reports on a regular basis to ensure a high quality standard in credit ratings.