

Credit rating agencies: integrity, transparency, responsibility, good governance and independence of activities

2011/0361(COD) - 15/11/2011 - Legislative proposal

PURPOSE: to amend Regulation (EC) n° 1060/2009 on credit rating agencies in order to reduce the risks to financial stability and restoring the confidence of investors and other market participants in financial markets and ratings quality.

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

BACKGROUND: through [Regulation \(EC\) No 1060/2009](#) on credit rating agencies, which entered into full application on 7 December 2010, credit rating agencies (CRAs) are required to comply with rigorous rules of conduct in order to mitigate possible conflicts of interest, ensure high quality and sufficient transparency of ratings and the rating process. An amendment to [Regulation \(EU\) No 513/2011](#) entrusted the European Securities and Markets Authority ([ESMA](#)) with exclusive supervisory powers over the registration and supervision of CRAs.

Whilst providing a good basis, **a number of issues related to credit rating activities and the use of ratings have not been sufficiently addressed** in the existing CRA Regulation. These relate notably to: (i) the risk of overreliance on credit ratings by financial market participants, (ii) the high degree of concentration in the rating market, (iii) civil liability of credit rating agencies vis-à-vis investors, (iv) conflicts of interests with regard to the issuer-pays model and CRAs' shareholder structure. The specifics of sovereign ratings which became evident during the current sovereign debt crisis are also not specifically addressed in the current CRA Regulation.

The Commission pointed to these open issues in its Communication of 2 June 2010 entitled ["Regulating financial services for sustainable growth"](#).

On 8 June 2011, the European Parliament adopted [a non-legislative resolution](#) supporting the need to enhance the regulatory framework for credit rating agencies. The European Council of 23 October 2011 concluded that progress is needed on reducing overreliance on credit ratings.

At the international level, in October 2010 the Financial Stability Board (FSB) issued principles to reduce authorities' and financial institutions' reliance on CRA ratings. Those principles were endorsed by the G20 Seoul Summit in November 2010.

Lastly, the Commission recently addressed the question of overreliance on ratings by financial institutions in the context of the [reform of the banking legislation](#). It proposed a similar provision in the [draft amendment to the Directives on UCITS and on managers of alternative investment funds](#), which are presented in parallel to this proposal for a Regulation.

IMPACT ASSESSMENT : different policy options were considered in order to address the problems identified and thus reach the corresponding specific objectives:

- to diminish the impact of "cliff" effects on financial institutions and markets by reducing reliance on external ratings;

- to mitigate the risks of contagion effects linked to sovereign ratings changes;
- to improve credit rating market conditions with a view to improving the quality of ratings;
- to ensure a right of redress for investors who have suffered losses due to a credit rating issued by a CRA that has infringed the CRA Regulation; and
- to improve the quality of ratings by reinforcing the independence of CRAs and promoting sound credit rating processes and methodologies.

Amongst the preferred policy options are the following: (i) reduction of overreliance by financial institutions on external ratings by reducing the importance of external ratings in financial services legislation; (ii) issuers' disclosure regarding the underlying asset pools of structured finance products to help investors to make their own credit risk assessment; (iii) quality of sovereign ratings to be improved through verification of underlying information and publication of the full research report accompanying the rating; (iv) comparison of ratings from distinct rating agencies, facilitated by promoting common standards for rating scales and a European Rating Index (EURIX), to improve choice; (v) mandatory rotation of CRAs; (vi) setting up a right of redress for investors against CRAs; (vii) strengthening the rules on the disclosure of rating methodologies.

Lastly, there would be additional costs for financial firms resulting from the requirements to enhance internal risk management and the use of internal rating models for regulatory purposes and for issuers due to enhanced disclosure requirements. CRAs will also incur additional recurring compliance costs to mitigate risks of contagion effects linked to sovereign ratings.

Neither the measures to improve competition nor the preferred options dealing with CRA independence would entail any significant costs.

LEGAL BASIS: Article 114 of the Treaty on the Functioning of the European Union. (TFEU).

CONTENT: the proposal aims to amend Regulation No 1060/2009 on credit ratings agencies. **1) Use of credit ratings:** the proposal requires certain financial institutions to make their own credit risk assessment. They should therefore **avoid relying solely or mechanistically on external credit ratings** for assessing the creditworthiness of assets. Furthermore, ESMA, EBA and EIOPA should not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger mechanistic reliance on credit ratings by competent authorities or financial market participants.

- Issuers are obliged to disclose specific information on structured finance products on a continuing basis, in particular on the main elements of underlying asset pools for structured finance products necessary for investors to make their own credit assessment and thus avoid the need to rely on external ratings. This information is to be disclosed through a centralised website operated by ESMA.
- Issuers (or their related third parties) who solicit a rating must engage two credit rating agencies, independent from each other, to issue two independent credit ratings in parallel on the same structured finance instruments.

2) Independence of credit ratings agencies: this group of amendments establishes stricter rules on independence which aim to address conflicts of interests with regard to the issuer-pays model and CRAs' shareholder structure:

- The proposal **prevents any member or shareholder** of a CRA that holds a participation of at least 5% to hold 5% or more in any other CRA, unless the CRAs in question are members of the same group;
- A new article introduces a **rotation rule** for the CRAs engaged by the issuer to either rate the issuer itself or its debt instruments. The CRA engaged should not be in place for **more than 3 years or for more than 1 year** if it rates more than ten consecutively rated debt instruments of the issuer.

This rotation rule is expected significantly to **mitigate the potential conflicts of interest issues** relating to the issuer-pays model. Moreover, the Commission will continue to monitor the appropriateness of credit rating agencies' remuneration models and will submit a report thereon to the European Parliament and the Council by 7 December 2012.

3) Disclosure of information on methodologies of CRAs, credit ratings and rating outlooks: this group of amendments strengthens the rules on the disclosure of rating methodologies, with a view to promoting sound credit rating processes and, in fine, improve rating quality.

- New provisions lay down **procedures for the preparation of new rating methodologies** or the modification of existing ones. They require the consultation of stakeholders on the new methodologies or the proposed changes and on their justification. Furthermore CRAs should submit the proposed methodologies to ESMA for the assessment of their compliance with existing requirements.
- Each CRA will be obliged to **correct errors in its methodologies** or in their application, as well as to inform ESMA, the rated entities and generally the public of such errors.

4) Sovereign ratings: rules applying specifically to sovereign ratings (the rating of a State, a regional or local authority of a State or of an instrument for which the issuer of the debt or financial obligation is a State or a regional or local authority of a State) are particularly reinforced:

- CRAs are required to assess sovereign ratings more frequently (**every six months instead of every twelve months**);
- CRAs must publish a **full research report** when issuing and amending sovereign ratings, in order to improve transparency and enhance users' understanding. Sovereign ratings should only be published **after the close of business and at least one hour before the opening of trading venues in the EU**;
- CRAs must be **transparent as to the allocation of staff** to the ratings of different asset classes (i. e. corporate, structured finance, sovereign ratings).

5) Comparability of credit ratings: these amendments promote the comparability of credit ratings and provide for more transparency on fees charged for credit ratings.

- CRAs must communicate their ratings to ESMA, which would ensure that all available ratings for a debt instrument are published in the form of a **European Rating Index (EURIX)**, freely available to investors;

- ESMA is empowered to **develop draft technical standards**, for endorsement by the Commission, on a harmonised rating scale to be used by CRAs. All ratings would need to follow the same scale standards, ensuring that investors can compare ratings more easily.
- **fees charged by CRAs** to their clients for the provision of ratings (and ancillary services) should be non-discriminatory (i.e. based on actual cost and the transparency pricing criteria) and not based on any form of contingency (i.e. not depend on the result or outcome of the work performed).
- CRAs must annually disclose to ESMA **a list of fees charged** to each client, for individual ratings and any ancillary service.
- ESMA must undertake some **monitoring activities regarding market concentration** and the Commission will prepare a report on this issue.

6) Civil liability of credit rating agencies vis-à-vis investors: CRAs will bear such liability where they infringe, intentionally or with gross negligence, the CRA Regulation, thereby causing damage to an investor having relied on a credit rating of such CRA, provided the infringement in question affected the credit rating.

BUDGETARY IMPLICATIONS: the Commission's proposal has no impact on the European Union budget. In particular, tasks that would be entrusted to ESMA would not entail additional EU funding.

DELEGATED ACTS: the proposal contains provisions empowering the Commission to adopt delegated acts in accordance with Article 290 of the Treaty on the Functioning of the EU.