EU-Regulation

CREDIT RATING AGENCIES

Status: 16.02.09

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Regulation: The Regulation aims to create a common framework for the activities of credit rating agencies and the surveillance thereof.

Groups Affected: Credit rating agencies, companies rated by them and investors

Pros: (1) Transparency obligations for credit ratings strengthen the stability of the financial market.
(2) In the future as well, authorities may not interfere with the content of credit ratings.

Cons: (1) The Regulation is also valid for credit rating agencies whose ratings are not to used in calculating the own funds requirements of regulated financial service providers.
(2) Only credit ratings from agencies based in the EU may be used without restriction.
(3) Banks may only buy or sell rated financial products on behalf of third parties if the credit rating comes from an agency registered in the EU.

CONTENT

Title

Proposal COM (2008) 704 of 12 November 2008 for a **Regulation** of the European Parliament and of the Council **on Credit Rating Agencies**

Abstract

- **Scope**
  – Credit ratings are opinions regarding the creditworthiness of companies, credit-commitments or debts which are assigned a rating category (e.g. AA) using established processes (Art. 2 (1)).
  – Credit ratings are used by investors to evaluate the creditworthiness of their investments. In addition, banks, insurance companies and other regulated financial service providers may use credit ratings to calculate the required own funds which they must retain due to regulatory provisions (Art. 81 Directive 2006/48/EC ("Basel II")).

- **Registration obligation for credit rating agencies**
  – A credit rating agency may only become active in the EU if it is registered and provides proof that it complies with the requirements of this Regulation (Art. 35).

- **Applicability of credit ratings by regulated financial service providers**
  – In the future, banks, insurance companies and other regulated financial service providers may only use credit ratings from agencies registered and based in the EU to calculate their required own funds. (Art. 2 (1) and Art. 4 (1))
  – Banks and investment firms may only buy or sell rated financial products on behalf of clients if the rating comes from an agency registered in the EU (Art. 4 (2)).

- **Independence and conflicts of interest**
  – Conflicts of interest may not influence a credit rating. The administrative or supervisory board of a credit rating agency must therefore contain at least three independent, non-executive members,
    - who are responsible for the independence of the credit rating process and for ensuring that conflicts of interest are properly identified, managed and disclosed,
    - whose remuneration is not dependent on the business success of the agency and whose non-extendable term of office lasts no more than five years (Art. 5 (1), Annex I Sections A and B).
  – The following is valid for analysts and other persons directly involved in a credit rating:
    - They must possess "appropriate knowledge and experience" (Art. 6 (1)).
    - They may only be involved in credit ratings for the same company for a continuous period not exceeding four years. Renewed involvement is only permitted after two years have passed. This rotation mechanism does not apply to credit rating agencies with fewer than 50 employees. (Art. 6 (4)(5))
    - Their remuneration may not be contingent on the amount of revenue that the agency derives from the rated company (Art. 6 (1)(2)(6)).
    - A minimum of six months must have lapsed since the credit rating before they may take up a key management position with the rated company. Each time an analyst joins a rated company, the agency must review the analyst's ratings for the new employer from the preceding two years (Annex I, Section C (1)(7)).

- **Quality of rating methodologies**
  - A credit rating agency must analyse all information available that is of "relevance" to its rating methodologies and subsequently publish the sources. It must ensure that this information is of "sufficient" quality and derived from reliable sources. (Art. 7 (2) in conjunction with Art. 8 (2) and Annex I, Section D)
  - A credit rating agency must disclose which methodologies, models and key rating assumptions it uses in its rating process. If the agency makes changes to these, it must immediately announce which ratings are affected by this. It must review the affected credit ratings "as soon as possible" and not later than within six months. (Art. 7 (1)and (5)).
  - A credit rating agency must monitor if changes to the macroeconomic or financial situation haven an impact on credit ratings that are already assigned and "review" these ratings" where necessary" (Art. 7 (4)).

- **Transparency**
  - A credit rating agency must disclose the following information about itself:
    - on a continually updated basis: information regarding current and potential conflicts of interest, its policies on employee remuneration, ancillary activities, its credit rating results to date and previous credit rating activities. (Art. 9 (2) and Annex I, Section E, part I)
    - anually: A "transparency report" including information on its legal structure and ownership, its revenue (divided into credit rating and non-credit rating services) and its quality control system. It must also disclose the names of those rated companies from which it receives over 5% of its yearly revenue. (Art. 10 and Annex I, Section E, part III)
  - When publishing a credit rating, a credit rating agency must indicate whether it considers the information available to be satisfactory and whether it has verified the information provided by the rated company. (Annex I, Section D, part I)
  - A credit rating agency must submit a list of its 20 largest clients by revenue to the supervisory authorities in the EU State where its headquarters are based on an annual basis. It must also list all clients that have made a disproportionate contribution to the increase in revenue. (Art. 9 (3) and Annex I, Section E, part II)
  - A credit rating agency must identify credit ratings carried out without a client order ("unsolicited credit ratings") with a different credit rating category. It must state that it had no access to the accounts of the rated company. (Art. 8 (5))

- **Special provisions for credit ratings of structured finance instruments**
  - It must be possible to clearly recognise credit ratings of "structured finance instruments" (in particular securitised credits) as such. In disclosing such credit ratings an agency must therefore:
    - use special credit rating categories or state in a report how the risk and associated credit rating methods differ from "classic" company ratings (Art. 8 (3));
    - inform the public of whether assets underlying the securitisation were rated by them or whether the rating was taken from other credit ratings agencies (Annex I, Section D, part II).
  - If a credit rating agency uses credit ratings from other agencies as its basis when assessing structured finance instruments or (underlying) assets but subsequently deems the creditworthiness to be worse, it must justify this (Art. 7 (3)).

- **Registration procedures and surveillance**
  - The application for registration is to be submitted to the Committee of European Securities Regulators (CESR) which shall transmit it to the competent authority of the home Member State (Art. 13 (3)).
  - The competent authority will communicate a draft decision to CESR after no more than 40 days. CESR may oppose the planned decision. If the national authority chooses not to follow the opinion of CESR, it shall motivate its decision. (Art. 15 (1)(2))
  - CESR can work out guidelines on the registration process, the required disclosure of information and enforcement through competent authorities (Art. 18 (2)).
  - The competent authority monitors compliance with the requirements of the Regulation. However, in doing this it may not interfere with the content of credit ratings. (Art. 20 (1))
  - If a credit rating agency no longer meets the requirements of the Regulation, after consultation with CESR, the authorities from each state where the agency is active can:
    - withdraw the registration of the credit rating agency,
    - impose a Community-wide, temporary prohibition on issuing credit ratings for this agency,
    - impose Community-wide suspension of the use of credit ratings from this agency. (Art. 21 and 22)

Changes Compared to the Status Quo

- To date, the legal requirements of credit rating agencies are only formulated in the Capital Requirements Directive (Annex VI, part 2 of Directive 2006/48/EC ("Basel II")). In accordance with this, banks may only make use of credit ratings to calculate the required own funds if these are objective, independent, credible and transparent. The Committee of European Banking Supervisors (CEBS) has issued non-binding guidelines on the recognition of such credit rating agencies.
- In accordance with Directive 2003/125/EC, credit rating agencies "should" adopt internal procedures to ensure that credit ratings are appropriate and that conflicts of interest are disclosed, but they are not obliged to do this. The International Organisation of Securities Commissions code of conduct is also voluntary.

Statement on Subsidiarity

The credit ratings produced by a credit rating agency will be used in all Member States, not just the EU State where it its headquarters are based. In order to guarantee a consistent level of protection, the Commission believes that an EU-wide, harmonised legal framework for credit rating agencies is necessary.

Political Context

In its own-initiative report dated 28 January 2004, the European Parliament encouraged the regulation of credit rating agencies. On 9 October 2007, the EU Economic and Financial Affairs Council called on the Commission to analyse possible conflicts of interest of and the regulatory approval process for credit rating agencies. EU-Commissioner for the Internal Market and Services, Charlie McCreevy, yielded to growing political pressure with the present Regulation proposal.

Legislative Procedure

12.11.08	Adoption by the Commission
01.12.08	Council debate, without decision
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for influencing the Political Process

Leading Directorate General:	DG Internal Market and Services
Committees of the European Parliament:	Economic and Monetary Affairs (leading), rapporteur Jean-Paul Gauzès (EPP-ED Group, F); Legal Affairs
Committees of the German Bundestag:	Finance (leading); Consumer Protection; Affairs of the EU; Economics and Technology; Budget
Decision Mode in the Council:	Qualified majority (adoption with a majority of the member states and 255 of 345 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 95 EC Treaty (Internal Market)
Form of legislative competence:	Concurrent legislative competence
Legislative procedure:	Art. 251 EC Treaty (Codecision)

ASSESSMENT

Economic Impact Assessment

Ordoliberal assessment

Credit ratings offer investors a considerable advantage in allowing them to (partially) avoid the costly and time-consuming process of needing to investigate the default risk of companies or financial products themselves. Credit ratings thus help reducing information asymmetries.

However, the Regulation sheds light on the following fundamental problem: The legal requirements imposed on financial service providers, which are supposed to ensure the stability of the financial system, explicitly draw on the help of credit ratings. For example, in Directive 2006/48/EC ("Basel II"), the EU acknowledges credit ratings as the most important instrument for estimating credit risks: In allowing banks, insurance firms and other regulated financial service providers to use credit ratings when determining how much own funds they must hold against their credit risks, the EU affords the agencies a near sovereign role in the stabilisation of the financial system. The endeavours of legislators to subject credit rating agencies to a Regulation are a logical consequence of this evolution but go too far. **It should be left up to individual credit rating agencies to decide whether or not they want to accept a quasi-statutory role in addition to producing non-binding credit ratings.** Only for such agencies is a Regulation necessary.

For agencies whose credit ratings are also to be used in calculating own funds requirements, the transparency obligations and obligations to disclose the models, methodologies and key rating assumptions underlying credit ratings – in particular for structured financial products – **are to be welcomed.** They enable credit ratings to be verified by financial service providers and therefore strengthen the quality of credit ratings, which has a positive effect on the stability of the financial market. CESR guidelines are important in enabling the effective verification of credit ratings: They should in fact also safeguard the transparency necessary for this.

Credit ratings that are not to be consulted in calculating equity requirements do not have to be regulated: They cannot jeopardise the stability of the financial market. Protection for users of credit ratings is also unnecessary. Investors know that ratings are not objectively "correct", but represent the result of investigations which are inevitably full of incertitude. Investors are also aware that credit ratings are usually financed by companies that either want to be rated themselves or are interested in selling the rated financial instruments.

The Regulation stipulates that **competent authorities may not interfere in the actual credit rating of a company or financial product**. **In the interest of the quality of credit ratings**, this **is to be greatly welcomed.**

Expectations of the provisions for avoiding conflicts of interest are unrealistic. The proposed remuneration models, the rotation of analysts and the waiting period before taking up a position at a rated company will have limited effect. Credit ratings are not performed individually but are produced by teams. An individual analyst has limited possibilities of influencing a credit rating.

Impact on Efficiency and Individual Freedom of Choice

Provided that a sufficient number of investors make use of **the monitoring possibilites** offered by the **Regulation,** it **will strengthen the competition for quality** between credit rating agencies. **This increases economic efficiency in the medium term**: Appropriate risk assessments are a prerequisite for the efficient allocation of limited capital by investors.

In stipulating that only credit ratings from agencies in the EU will be recognised for supervisory purposes, the Commission intends to make the Regulation a worldwide standard. As a result, credit ratings produced by American credit rating agencies could only be used in the EU if the agencies were to set up a registered office in the EU and meet the requirements of the Regulation. However, if the US authorities were to make a similar demand, credit rating agencies would have to satisfy two different regulatory systems. **It would be more efficient to recognise equivalent supervisory standards in third countries.** Credit ratings from monitored agencies based outside the EU could therefore be permitted.

The Regulation prohibits financial service providers from **selling financial products rated by credit rating agencies that do not comply with the Regulation**. **This paternalism** reduces client investment possibilities **and should be abandoned**.

Impact on Growth and Employment

The Regulation entails cost increases for credit rating agencies which could lead to higher prices for processing credit ratings. High credit rating costs hinder access to the capital market for companies, and therefore to the financial means that are necessary for investments. On the other hand, adequate credit ratings reduce the danger of capital losses and therefore strengthen growth potential.

Impact on Europe as a Business Location

The higher level of transparency of the Regulation enables a competition for quality between rating agencies. This strengthens the EU's financial markets stability and consequently also the EU as a business location.

Legal Assessment

Legislative Competence

Art. 95 EC Treaty is the relevant rule of competence for completion of the internal market for financial services.

Subsidiarity

Unproblematic.

Proportionality

The requirement that employees involved in credit ratings may not take up an executive position with a company for which he or she has produced ratings within six months is disproportionate. This sanction is unnecessary for preventing the credit rating from being influenced by the employee concerned. This objective is achieved in obliging the credit rating agency to review that employee's credit ratings for the new employer from the preceding two years and to correct credit ratings which are "too favourable".

Compatibility with EU Law

The demands placed on credit rating agencies in Annex VI, part 2 of the Capital Requirements Directive 2006/48/EC ("Basel II") would be made obsolete by the proposed Regulation and, in the interest of legal consistency and legal certainty, should be repealed.

Compatibility with German Law

The temporary **prohibition for an analyst of moving from a credit rating agency to a company** for which he or she has previously produced credit ratings **is an inadmissible limitation to occupational freedom** (Art. 12 (1) German Basic Law (GG)).

Alternative Policy Options

The Regulation should only apply to credit ratings which are to be used to calculate required own funds.

Possible Future EU Action

A revision of the role of credit rating agencies in European Regulatory Law is not to be ruled out.

Conclusion

The Regulation is only necessary for credit rating agencies which are to be use for calculating the own funds needs of financial service providers. The use of credit ratings from agencies in third countries should also be permitted for this use if they are subject to similar regulatory standards. The transparency obligations for credit ratings used for regulatory purposes enable investors to review credit ratings more easily and strengthen quality competition. Furthermore, financial service providers should be able to buy and sell rated financial products on behalf of their clients also when no EU credit rating exists.