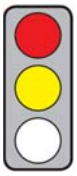
CREDIT RATING AGENCIES

Status: 20 September 2010

MAIN ISSUES

Objective of the Regulation: The supervision of credit rating agencies will be centralised within the European Securities and Markets Authority (ESMA).

Parties affected: Credit rating agencies, rating users, issuers of rated securities, supervisory authorities.



Pro: Centralising the oversight of credit rating agencies with ESMA helps prevent national supervisory authorities from undertaking their own and different supervisory measures.

Contra: (1) It is not necessary to centralise the supervision of rating agencies. It suffices to maintain the federal supervisory structures proposed for ESMA; this also applies to credit rating agencies.

(2) It is controversial whether or not a centralised supervision of credit rating agencies is in line with EU law.

(3) The special rules for structured financial products will only have a limited effect.

CONTENT

Title

Proposal COM(2010) 289 of 2 June 2010 for a **Regulation** of the European Parliament and the Council amending Regulation (EC) No. 1060/2009 **on credit rating agencies**.

Brief Summary

The articles quoted refer to the Regulation (EC) 1060/2009 ("Rating-CR") to be amended.

- **Background**
  - The 2009 Rating-CR regulates the registration and supervision of credit rating agencies at an EU-wide level. National supervisory authorities perform this duty on their own or within colleges. The Committee of European Securities Regulators (CESR) has merely a coordinating function.
  - In September 2009, the Commission presented its proposals regarding the establishment of a European System of Financial Supervisors (ESFS). Parts of the ESFS are to become a European Securities and Markets Authority (ESMA), which is to replace the CESR [COM(2009) 503; see CEP Policy Brief].

- **Registration and Supervision through ESMA instead of national regulatory authorities**
  - Responsibility for the registration and ongoing supervision of credit rating agencies is to be assigned by the national supervisory authorities completely to the staff of ESMA. The same applies to the recognition of credit rating agencies from non-EU countries and the revocation of registration (amended Art. 4 (3), Art. 5, Art. 20).
  - ESMA charges the credit rating agencies with fees covering the full registration and supervision costs. At the same time, such fees must correspond to the respective size and economic strength of the credit rating agency concerned (amended Art. 19).

- **Special rules for ratings of structured finance instruments**
  - The Commission is not satisfied with the rating quality of structured finance instruments (usually credit securitisations). They claim that issuers paying for the rating of their own products leads to exaggerated positive ratings. (Recital 5)
  - The Commission wishes to promote transparency and competition in the rating of structured finance instruments with the help of the following new provisions (new Art. 8a (1) and (2)):
    - The issuer of a structured finance instrument must provide on a password-protected website all information required by the rating agency, which they appoint, in order to be able to carry out the rating.
    - The issuer must provide any other registered credit rating agency with access to said data upon request. A requesting agency must guarantee that the information concerned be treated with due confidentiality and, in at least 10% of cases, also publish their own cost-free rating of the securitisation concerned.
    - Credit rating agencies must, at all times, provide their registered competitors with an overview over all ongoing rating procedures of structured finance instruments (new Art. 8b).
  - The content of a rating must be influenced neither by ESMA nor by any national supervisory authority. (Art. 23)

- **Distribution of supervisory powers between ESMA and national supervisory authorities**
  - ESMA's staff alone is responsible for the registration and oversight of credit rating agencies. National supervisors are responsible for reviewing whether or not a financial institution uses only ratings by agencies duly registered for the fulfillment of regulatory obligations (Art. 21 and Art. 25a Abs. 1).
  - ESMA is empowered with comprehensive investigatory rights and rights to request information. This includes, in particular, the possibility to demand any document or data, to summon and hear persons and to conduct on-site inspections, even without prior announcement (new Art. 23a – 23c).

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- National supervisory authorities must, upon ESMA's request, assist ESMA in carrying out their duties (new Art. 23b (3)).
- On-site inspections are subject to an investigation decision adopted by ESMA.
  - Such an investigation decision also authorises ESMA to impose coercive measures and penalty payments in case a person refuses to cooperate.
  - National law may provide for a court authorisation of the coercive measures and penalty payments. However, the competent court may only control whether or not the ESMA decision is authentic and whether the coercive measures envisaged are arbitrary or excessive.
  - The lawfulness of ESMA's investigatory decision is subject exclusively to the review of the European Court of Justice (ECJ). (New Art. 23c (2), (7), (8) and 9)
- Should ESMA discover a breach of obligation it may, without involving the national authorities or the Commission, having heard the party concerned take supervisory measures (amended Art. 24 and 25).

- **Developing binding technical standards by ESMA**
  - Within ESMA, the national supervisory authorities decide by qualified majority on the technical standards required for:
    - the information to be provided in the registration process and
    - the disclosure of changed ratings and historical failure rates.
  - The standards are adopted by the Commission in the form of either a regulation or a decision (amended Art. 21 (3) in conjunction with Art. 7 and Art. 29 (1) of the Proposal COM(2009) 503 on the establishment of ESMA).

- **Fines and penalty payments**
  - The competent national authorities may impose fines on credit institutions if they use credit ratings for regulatory purposes provided by credit rating agencies not registered pursuant to the Regulation (Art. 4 (1) and amended Art. 36 (1) sub-sec. (1)).
  - A further 45 possible breaches are listed in the new Annex III. If a credit rating agency commits any of these breaches "intentionally or negligently", the Commission may, at ESMA's request, impose a fine of up to 20% of the annual income or turnover on the credit rating agency (new Art. 36a).
  - At ESMA's request, the Commission may also impose daily penalty payments in order to enforce the law to an amount of up to 5% of the daily turnover of credit rating agencies (new Art. 36b).
  - The review of imposed fines and penalty payments is subject to the ECJ (New Art. 36e).

- **Substantiation through delegated acts**
  The Commission will substantiate the Regulation through the adoption of delegated acts pursuant to Art. 290 TFEU. This applies to both the definition of criteria determining fines and to the acceptance of ratings from third countries, as well as to the adoption of a scale of charges. (New Art. 38a to 38c)

Changes Compared to the Status Quo

- Most of the supervisory duties of national supervisory authorities regarding credit rating agencies is to be assigned to the staff of the European Securities and Markets Authority (ESMA).
- Until now it has always been the national supervisory authority of the credit rating agency's home state which decided on the registration application and supervisory measures. Where credit rating agencies have subsidiaries in countries outside the EU, or where its ratings are used on a broad basis in other states, the national supervisory authorities discuss the case concerned in a joint "college". In case of conflicting opinion, however, each national supervisory authority is free to take its own supervisory measures. In future, ESMA alone will decide on the according measures.
- To date, issuers of structured financial products are not obliged to convey information to credit rating agencies, other than the one mandated with drawing up the rating.
- As yet there are no European rules for using ratings in the field of alternative investment funds (AIFM). The Regulation Proposal COM(2009) 207 for AIFM, which is currently under dispute, provides for an obligatory quantification of risks. In future, AIFM are to be obliged to apply only those ratings which comply with the amended Rating Regulation.
- To date there has been no final catalogue of infringements entailing fines nor any EU-wide consistent penalty payments.
- There are no significant changes to the content of the provisions regarding the registration, transparency and quality credit rating agencies and the rules on the acceptance of credit rating agencies from non-EU states.

Statement on Subsidiarity by the Commission

The Commission states that in view of the global character of ratings, the supervision through national authorities is not a "long-term" solution. It stresses that the supervision of the use of ratings will remain under the responsibility of national supervisory authorities.

Policy Context

In June 2009, the European Council agreed to the EU Commission's announcement [COM(2009) 252; see CEP Policy Brief] that it intended to establish an EU supervision of credit rating agencies. Three months later the

Commission proposed establishing a European Securities and Markets Authority (ESMA) [COM(2009) 503; see CEP Policy Brief], which was to take on this task, on the basis of a "future Regulation on credit rating agencies".

Legislative Procedure

02 June 2010	Adoption by Commission
Open	Adoption by European Parliament and the Council, publication in the Official Journal, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market and Services
Committees of the European Parliament:	Economic and Financial Affairs (in charge), rapporteur: Jean-Paul Gauzès (EPP Group, FR); Legal Affairs
Committees of the German Bundestag:	Finance (in charge); Food, Agriculture and Consumer Protection; Affairs of the European Union; Economics and Technology
Decision Mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes)

Formalities

Legal competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

Statutory requirements for credit rating agencies are legitimate in view of their relevance for the stability of the financial market. The present Amendment Proposal mainly adopts the material provisions of the existing Rating Regulation [(EC) No. 1060/2009; regarding the content requirements as to credit rating agencies see CEP Policy Brief].

Therefore, it is still to be criticised that the Regulation is also to apply to credit rating agencies whose ratings are not intended for use with regulatory requirements, such as calculating the necessary equity capital of banks, and thus do not exercise a quasi-sovereign function.

Unlike the other tasks of the three planned European Supervisory Authorities – together with ESMA, the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) – the Commission intends to **centralise the supervision of credit rating agencies** at EU level. ESMA's staff - and not the 27 national banking supervision authorities – will then decide on supervisory measures. Such centralisation is justifiable as it helps prevent national supervisory authorities from taking different supervisory measures in the case of a conflict. This could happen pursuant to Art. 35 of the current Rating CR [(EC) No. 1060/2009]. However, this centralisation is **not absolutely necessary, for the existing problems could also be tackled by simply deleting Art. 35 from the current Rating CR**.

If this step were taken, the federal supervisory model proposed for the remaining duties of the European supervisory authorities would suffice for the supervision of credit rating agencies; this model enables the clear division of competences between the individual supervisory authorities and a consistent application of the rules for credit rating agencies. This is guaranteed by the scrutiny procedure regarding the application of statutory requirements and the binding arbitration of conflicts within ESMA by way of majority decisions of the national supervisory authorities.

Fines for infringements do not have to be imposed centrally by ESMA either. According to existing law, the authorities of the home country of the credit rating agency concerned decide on the amount. In order to avoid a "race to the bottom", which could lead to agencies being set up where fines are lowest, EU-wide minimum requirements for fines would suffice.

As a result of centralising the credit rating agencies at EU level, smaller agencies, which operate in one country only, are also to be monitored by ESMA in Paris. ESMA is not familiar with the work of such operations – for example, Bulgarian agencies which rate municipal bonds. Therefore, it is very likely that ESMA would re-delegate this type of supervisory duties back to the competent national supervisory authority. Here, too, the existing rule under the federal supervisory model is much better, since ESMA would not become active until serious conflicts arose.

The Commission's attempt to boost the oligopolistic market through **special rules for structured financial products** is laudable. However, the new **will have only limited effects**.

For in calculating the necessary equity capital, business banks do not have to take into account deviating ratings, which, for instance, are drawn up unsolicited : The Capital Requirement Directive (Directive 2006/48/EC, Annex VI, Part 3) stipulates that only ratings by agencies nominated by a bank need be taken as a basis. And as banks usually nominate one of the three market-dominating credit rating agencies, deviating ratings of other agencies normally have no relevance to banks. The chance for new credit rating agencies to establish

themselves on the market due to the now facilitated access to essential data of emitters is therefore rather limited.

Impact on Efficiency and Individual Freedom of Choice

Credit rating agencies must finance 100 percent of ESMA's supervision through fees. The Commission assumes annual costs to the amount of € 2.5 million. With 50 registered credit rating agencies (Source: Commission, financial statement on the Proposal), this would lead to average costs of € 50,000 per agency per year.

Impact on Growth and Employment

If, contrary to expectation, the special rules for structured financial products lead to more critical ratings by the market-dominating credit rating agencies, the financial products concerned will become more expensive. Banks will have to retain more equity capital and thus can grant less loans, which would have a negative impact on growth. Given that critical ratings are appropriate, however, they increase the stability of the financial system.

Impact on Europe as a Business Location

Insignificant.

Legal Assessment

Legislative Competence

The Amendment Regulation is – like the existing Rating Regulation – correctly based on Art. 114 TFEU.

Subsidiarity

The added value that a European supervisory system for credit rating agencies – resulting from the combination of the existing Rating Regulation and the proposed ESMA Regulation – would offer, as opposed to the existing federal supervisory system, is not recognisable.

Proportionality

The aim of establishing ESMA is to coordinate the supervisory duties of national authorities. Law enforcement generally remains subjected to national competencies. A deviation from this system is not necessary. Whether or not there has been an infringement of the Rating CR can be determined by the national supervisory authorities, and in case of doubt also through arbitration proceedings (Art. 11; COM(2009) 503). Otherwise, the Commission is entitled to assert infringement proceedings.

Compatibility with EU Law

Exercising the supervision of credit rating agencies is unavoidably connected with discretionary decisions. Therefore, **it is questionable whether or not the delegation of supervisory tasks to ESMA is in line with EU law**. For discretionary powers may be delegated only to institutions mentioned in the Treaty in relation to the exercise and control of such powers (ECJ, No. 9/56, *Meroni*).

The proposed **formal delegation of discretionary decisions on fines and penalty payments to the Commission**, which serves to circumvent the Meroni decision; is not an alternative: it is not consistent with the explicit Regulation target to set up **a supervision independent from politics**.

Compatibility with German Law

Unproblematic.

Alternative Action

The federal supervision in the form in which ESMA, EBA and EIOPA are organised is to be preferred to the proposed centralised supervision of credit rating agencies at EU level. For that purpose it suffices to simply delete Art. 35 of the current Rating CR [(EC) No. 1060/2009].

Possible Follow-up Action by the EU

The European Parliament's aim is that ESMA also takes over the supervision of the Central Counter Parties (CCP) for derivatives. A corresponding Commission proposal is to be expected soon. **The Commission could** use the centralised rating supervision as an opportunity to **delegate centralised supervisory powers also to the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA)**. It cannot be excluded that in future the Commission will propose having state securities rated by public agencies or the European Central Bank.

Conclusion

The centralisation of rating supervision with ESMA is justifiable but not absolutely necessary. At the same time, it is questionable whether or not it is in line with EU law. Therefore, the maintenance of federal supervisory structures for ESMA and for the supervision rating agencies is a better solution. For that purpose only Art. 35 of the existing Rating Regulation [(EC) No. 1060/2009] would have to be deleted. The proposed special rules for structured financial products will have limited effects only.