CREDIT RATING AGENCIES

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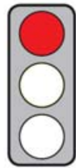
Centrum für Europäische Politik

MAIN ISSUES

Objective of the Regulation: The Commission wishes to see more competition among credit rating agencies and for them to be more independent. It would like to reduce the "overreliance" on ratings.

Parties affected: Credit rating agencies, ratings users, issuers, supervisory authorities.



Pro: The rotation rule increases the independence of credit rating agencies.

Contra: (1) Regulation is only justified in the case of ratings used for regulatory purposes. There is no need for regulation to boost competition.

(2) The rotation rule constitutes an unjustified distortion of competition. It reduces the quality of ratings and has a negative impact on growth.

(3) Double credit ratings for securitisations in the EU only weaken the stability of the financial market.

CONTENT

Title

Proposal COM(2011) 747 of 15 November 2011 for a **Regulation** of the European Parliament and of the Council amending Regulation (EC) Nor. 1060/2009 **on credit rating agencies**

Brief Summary

- **Object and scope**
  – The Commission proposes a number of changes to the existing Rating Regulation (No. 1060/2009). The stated aim of these new rules is to boost competition in the rating market, strengthen the independence of rating agencies and reduce the risk of "overreliance on ratings" by financial market participants. (Recital p. 8, 9 and 12)
  – The scope of the Regulation will in future also cover rating outlooks. These are statements regarding the likely direction a credit rating might take (Art. 3 (1) lit. w).
- **Contractual relationships of credit rating agencies (rotation)**
  – A credit rating agency may only issue ratings, against payment of remuneration, for issuers or their debt instruments for a maximum of three years, if done on the basis of a concluded contract (Art. 6b (1)).
  – During this three-year period, the credit rating agency may only rate a maximum of ten debt instruments of said issuer. There is, however, no restriction on the number of ratings that may be issued by the end of the first contractual year (Art. 6b (2)).
  – If an issuer enters into a contract with more than one credit rating agencies, then these provisions apply only to one credit rating agency. However, contractual relationships with any other agencies must not exceed a period of six years. (Art. 6b (3))
  – A credit rating agency may only draw up a new contract with an issuer if four years have elapsed since the end of the maximum duration period of the contractual relationship (Art. 6b (4)).
  – If a credit rating agency is replaced by another at the end of the maximum duration period of the contractual relationship, it must provide the incoming credit rating agency with a handover file. Such a file is to include all information necessary to ensure comparability with the ratings already carried out (Art. 6b (6) sub-para. 1).
- **Double credit ratings of structured finance instruments**
  – Structured finance instruments – normally credit securitisations – must be rated by at least two credit rating agencies. Each of them issues its own independent rating. (Art. 8b (1))
- **Rules for participation**
  – Shareholders and members of rating agencies holding at least 5% of the capital or voting rights must not (Art. 6a (1))
    - hold 5% or more of the capital and/or voting rights in any other credit rating agency;
    - be members of an administrative, management or supervisory board of any other credit rating agency, or appoint and/or recall such members;
    - have the power to exercise, or actually exercise, dominant influence or control over any other credit rating agency.
- **Transparency requirements for credit rating agencies vis-à-vis ESMA**
  – A credit rating agency must communicate on a yearly basis to the European Securities and Market Authority (ESMA):
    - the fees charged to each individual client for individual ratings and
    - its "pricing policy, including the fees structure and pricing criteria in relation to ratings for different asset classes". (Art. 11 (3) in conjunction with Annex I, Section E, Part II, No. 2 (1))
  – The fees charged to clients may not be "discriminatory" and must be based on "actual costs" (Art. 6 (2) in conjunction with Annex I, Section B, No. 3a).

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– If a credit rating agency wishes to change its models, methods or key assumptions, it must publish these changes together with an explanation of the reasons for and the implications of the changes, so that the "actors" affected are given the opportunity to provide feedback. The credit rating agency must not apply the changes until ESMA has approved them. (Art. 8 (5a) in conjunction with Art. 22a (3))

- **Transparency requirements for credit rating agencies vis-à-vis clients and the public**
  – A credit rating agency must inform the rated undertaking or state at least one full working day before publication of the credit rating or the rating outlook as to the results and the principal grounds on which the rating is based. This is to give the undertaking and/or state concerned an opportunity "to draw the attention of the credit rating agency to any factual errors". (Annex I, Section D, Part III No. 3 S. 2 in conjunction with Part I No. 3)
  – A credit rating agency must publish its "assumptions, parameters, limits and uncertainties", stress tests and information on cash-flow analysis with regard to all ratings (to date only with structured finance instruments) (Annex I, Section D, Part I, No. 2a).
- **European Rating Index**
  – Each credit rating agency must communicate all ratings to ESMA. It must express these ratings in line with a standard credit rating scale developed by ESMA; this is based on the metrical system. ESMA publishes the ratings of all issuers and finance instruments and calculates for each an average rating ("European Rating Index"). (Art. 11 a (1) and 2 in conjunction with Art. 21 (4a))
- **Special rules for sovereign ratings**
  – A sovereign rating is a credit rating where the entity rated is a state or a regional or local authority of a state (Art. 3 (1) lit. v). Credit ratings for states are normally drawn up without an order and are therefore free of charge.
  – The rules regarding the maximum duration period of the contractual relationship with a credit rating agency (Art. 6b (1 to 4) do not apply to sovereign ratings (Art. 6b (5)).
  – If a credit rating agency changes a sovereign rating or sovereign rating outlook, it must at the same time submit a "clear and easily understandable" report in which the credit rating agency presents:
    - an assessment of a series of prescribed indicators (such as GDP, inflation, budget balance, external trade balance) and details of the relative weight of these indicators;
    - a quantitative and qualitative evaluation of these indicators;
    - a "detailed description" of the "risks, limits and uncertainties" related to the rating change. (Annex I, Section D, Part III (1))
- **Civil liability of credit rating agencies**
  – A credit rating agency is liable to pay compensation to the investor when it has intentionally or through gross negligence committed any of the infringements listed in Annex III (in particular: conflict of interests, organizational requirements, disclosure rules). Such an infringement must have an impact on a credit rating "on which an investor has relied when purchasing a rated instrument". (Art. 35 a (1))
  – The Regulation provides for a (partial) reversal of the burden of proof. Where an investor is able to "establish facts from which it may be inferred" that a credit rating agency has committed an infringement, the credit rating agency must prove that it has not committed said infringement or that it had no such impact on the rating. (Art. 35 a (4)).
  – Liability must not be excluded or limited by agreement (Art. 35 a (5)).
- **"Over-reliance" on credit ratings by financial institutions and supervisory authorities**
  – Financial institutions – in particular banks and insurance companies, but also investment funds – must not "solely or mechanistically rely on credit ratings for assessing the creditworthiness" of corporates or financial instruments, but must carry out their own credit risk assessment. (Art. 5a sentence 1)
  – The EU supervisory authority EBA (banks), EIOPA (insurances) and ESMA (securities) must make sure that their reference to ratings in their technical standards does not result in supervisory authorities or financial market players "solely or mechanistically rely[ing] on credit ratings" (Art. 5b sup-para. 1 sentence 1).
- **Credit ratings from third countries**
  Financial institutions in the EU may only use credit ratings from non-EU countries ("third countries") if the credit rating agency concerned is subject to rules which are "equivalent" to those in the EU; in this matter the Commission decides. Third country rules can be deemed "equivalent" although no double rating for structured finance instruments is required. (Art. 5 (1) in conjunction with (6))

Statement on Subsidiarity by the Commission

Credit ratings issued in an EU Member State are used by financial institutions in the entire EU. According to the Commission, only rules that are applicable EU-wide can protect investors and markets.

Policy Context

The Rating Regulation, which did not take effect until 2009 [(EC) No. 1060/2009; see CEP Policy Brief], was amended only two years later in 2011 when credit rating agencies were subjected to the supervision by ESMA [Regulation (EU) No. 513/2011, see CEP Policy Brief]. On 8 June 2011, the European Parliament called upon the Commission to assess the establishment of an independent European Rating Foundation. However, because of the results of the impact assessment, the Commission distanced itself from this idea. The original plan of the Internal Market Commissioner Barnier to temporarily suspend the credit ratings of states did not receive a majority in the EU Commission.

Legislative Procedure

15.11.11 Adoption by Commission
Open Adoption by the European Parliament and 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 German Bundestag:	Economic and Monetary Affairs (in charge), rapporteur: Leonardo Domenici (S&D Group, IT); Internal Market and Consumer Protection; Legal Affairs
Committees of the German Bundestag:	Finance (leading); Legal; Economic; Budget; EU-Affairs
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 Impact Assessment

There is no convincing ordoliberal argument in favour of making statutory requirements for *all* credit rating agencies. Such requirements are only necessary for those credit ratings which are used for regulatory purposes – e.g. calculating own capital requirements. Therefore, the Commission should create a new category of unregulated credit ratings which cannot be used for regulatory purposes.
Irrespective of this, the content of the Commission's Regulation proposal is not convincing. The Commission intrudes deeply into contractual and entrepreneurial freedom by restricting the eligible contract duration and the eligible number of credit ratings. In so doing, its aim is to increase the independence of credit rating agencies (and in turn, the quality of credit ratings) as well as competition; neither are appropriate.
The mandatory rotation rule will lead to more frequent changes of credit rating agencies. Although this **can help increase the independence of credit rating agencies, the quality of credit ratings** will be diminished, as credit rating agencies will often have to start anew. Also, when the rating activity of a single agency is regularly interrupted, it becomes more difficult to judge the quality of a rating agency ex-post and to ensure comparability of ratings over time.
The alleged lack of competition does not justify the measures proposed by the Commission. It is true that the three large credit rating agencies – Standard & Poor's, Moody's and Fitch – dominate the market with a market share of almost 90%. However, legal barriers to entering the market – which the Commission indeed were to remove – do not exist. Their market dominance is much better explained by the fact that the majority of worldwide investors request ratings from these three credit rating agencies. The reason for this could be a mixture of credibility and international recognition. However, this market dominance is "contestable". That means, all competitors of the well-established credit rating agencies are free to strive for a similar reputation and recognition. **As an uncontestable market power is not given here, there is no need for regulation in terms of competition economics**. The same applies to the rules requiring that the fees charged to clients may not be discriminatory and must be based on actual costs.
The rotation rule represents a massive and unjustified promotion of new credit rating agencies. Institutions issuing more than ten securitisations per year must, from the third contract year on, mandate a non-established credit rating agency (see CEP Accompanying Document, in German). The market entry of such agencies is forced through by legislation and is based neither on their acceptance nor quality, and in the end, must be financed by the issuers. In view of the Commission's intention to promote new credit rating agencies, the proposed participation rules make sense, irrespective of the economic weakness of the overall concept. The point of these rules is to ensure that rotation leads to there being a sufficient number of mutually independent credit rating agencies available on the market.
By referring explicitly to ratings in the European own capital requirements, the EU has assigned to the credit rating agencies a quasi-public function. It is therefore logical that there be professional and qualitative requirements concerning the methods of credit ratings to be used for supervisory purposes. The proposed monitoring of new credit rating methods by ESMA is acceptable, though **there is the risk that investors** rely even more blindly on **credit ratings** if ESMA has approved these models. The same applies to the European Rating Index to be drawn up by ESMA.
Higher transparency requirements of credit rating agencies – instead of increased regulation – promise the most success. Investors should be enabled to better check whether or not the judgement of credit rating agency is convincing. **The disclosure** of assumptions and parameters on all credit ratings and the publication **of audit reports for sovereign credit ratings can** consequently **strengthen competition and the quality of ratings**.

The liability of credit rating agencies is justifiable in principle. In view of the uncertainty inherent in credit ratings, it is to be welcomed that the liability for the infringements listed under Annex III **only takes effect in the case of gross negligence**. Problematic is the fact that the concept of gross negligence does not exist in all EU countries to the same extent. Therefore, it cannot be excluded that liability takes effect too early and becomes too much of a deterrent. This **can distort the statements of credit rating agencies and be detrimental to the quality of credit ratings**.

The fact that the rule to draw up double ratings for structured finance products is directed at European issuers, weakens the financial market stability. It would make more sense to impose this obligation on financial institutions such as banks and insurance companies as part of the own capital requirements. Otherwise, incentives would be set to financial institution to invest in non-EU securitisations, for which only one single rating must be submitted and which therefore is cheaper.

As was the case in the Own Capital Directive [COM(2001) 453, see CEP Policy Brief], also here the Commission is pushing for ratings to play a minor role in the own capital deposit of financial institutions. It is still unclear which consequences this has for the use of the standard approach, which resorts to ratings and is used mainly by small banks.

Impact on Growth and Employment

The rotation rule makes finance instruments of European issuers less attractive for investors, as over the years there is no longer a rating issued by the same credit rating agency. This **could unsettle investors** if they are not sure whether rating changes are due to a deterioration in the creditworthiness of an issuer or to the different methods of the agencies. This makes the acquisition of capital more expensive for European issuers and thus **has a negative impact on growth**. Due to the substantial refinancing needs of European banks, this could also threaten financial stability.

Legal Assessment

Legal Competency

The Regulation is correctly based on Art. 114 TFEU (internal market).

Subsidiarity

Unproblematic.

Proportionality

Unproblematic. For more details on the rotation rule see below.

Compatibility with EU Law

Rotation interferes with Art. 16 of the EU-Charter of Fundamental Rights (entrepreneurial freedom), as during the four-year “cooling phase”, contracts between the respective credit rating agencies and issuers are prohibited. The Commission’s aim is to strengthen the independence of credit rating agencies. Such independence is valuable because credit ratings contribute to the functioning of the financial system. The Commission’s assumption (Recital 9) that the independence of credit rating agencies can only be ensured if more than two credit rating agencies alternate when rating an issuer, then from a *legal* standpoint – notwithstanding *economic criticism* – it is justifiable that the “cooling phase” takes longer than the maximum duration of a contract.

Compatibility with German Law

In Germany, damaged investors generally take legal action against their banks, claiming compensation due to poor investment counselling. The first action for damages against a US American credit rating agency was brought before the regional court of Frankfurt am Main. The claimant asserted that its decision to buy certificates of the now insolvent Lehman Brothers Inc. had been mainly based on the rating. The court found the action to be inadmissible as it did not have territorial jurisdiction. In the appeal procedure, the higher regional court (Oberlandesgericht) annulled the judgement on 28 October 2011 (Az. 21 U 23/11), though this is not yet legally binding; the basis for the claim is still being contested. Under consideration is a contract between the issuer and the credit rating agency that has protective effect and benefits a third party, here the investor. Still unclear is whether or not in future a claimant will only be entitled to enforce claims from the Regulation or may also refer to national rules for claims actions.

Alternative Action

A new category of ratings should be introduced which may not be used for regulatory purposes. For these ratings, regulation is therefore not necessary.

Conclusion

In terms of competition economics, there is no need to regulate credit rating agencies. In view of the financial market stability, a regulation is only justified if the ratings are used for regulatory purposes. The rotation rule represents a massive and unjustified promotion of new credit rating agencies. Though this can help increase the independence of credit rating agencies, it also reduces the quality of ratings and has a negative impact on growth. The disclosure of audit reports in sovereign ratings can strengthen the quality of ratings. The liability of credit rating agencies threatens to distort their statements. The rule on double ratings for structured finance instruments jeopardizes the stability of the financial market.

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