

EPFSF Briefing

A new framework for Credit Rating Agencies

Background

The financial market turmoil has raised questions regarding the methods and models used by credit rating agencies (CRAs), in particular as they pertain to the rating of structured finance instruments. Consequently, many commentators consider that CRAs have contributed to the current financial market turmoil. As a result, market participants' confidence in the performance of CRAs and in the robustness of ratings has suffered, prompting policymakers to review the role of CRAs. Given the global nature of credit ratings, such work has been coordinated internationally through the Financial Stability Forum (FSF). The FSF seeks to ensure a globally consistent approach to oversight and regulation of CRAs and avoid a fragmentation of CRAs' role across financial markets. Accordingly it is following not just the EU's proposals but also developments elsewhere, including at IOSCO and the SEC. The FSF has focused on addressing concerns in the following areas:

- **The quality of the rating process**

CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products.

- **Differentiated ratings and expanded information on structured products**

CRAs should differentiate ratings on structured finance from those on bonds, and expand the initial and ongoing information provided on the risk characteristics of structured products.

- **CRA assessment of underlying data quality**

CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.

- **The uses of ratings by investors and regulators**

Investors should address their over-reliance on ratings. Investor associations should consider developing standards of due diligence and credit analysis for investing in structured products[#].

Existing framework under which CRAs operate

IOSCO

In 2004 the International Organization of Securities Commissions (IOSCO) published a Code of Conduct Fundamentals for CRAs (the IOSCO code), which was designed to address regulatory and industry concerns over the conduct of business of the CRAs.

The IOSCO code, which was updated in June 2008, contains provisions to promote business controls, address concerns over conflict of interest in the rating of structured finance products, drive more robust assessment of data quality and create greater transparency of the methodologies and limitations of credit ratings.

IOSCO will report further (planned for January 2009) on developing mechanisms by which national regulators can coordinate their monitoring of CRAs with the substance of the IOSCO Code of Conduct and on setting the terms and conditions of information exchange and cooperation. At the same time, it will also publish its review of CRAs' adoption of codes of conduct based on the revised IOSCO Code.

[#] See joint ESF, EFAMA and IMA guidelines of 11/12/2008 at <http://www.europeansecuritisation.com/dynamic.aspx?id=1658>

SEC

The US Securities and Exchange Commission (SEC) operates a recognition system for CRAs as NRSROs (Nationally Recognised Statistical Rating Organisations), a concept going as far back as 1975. Following the adoption of the Credit Rating Agency Reform Act of September 2006, the SEC promulgated rules, in June 2007, regarding public disclosure, recordkeeping, financial reporting, and substantive requirements to ensure that CRAs conduct their activities with integrity and impartiality.

In December 2008 the SEC approved further measures to strengthen its oversight of CRAs by imposing additional requirements on CRAs, in particular related to structured finance ratings. The SEC also proposed additional measures related to transparency and competition concerning CRAs.

Existing EU regulation

Currently, CRAs are not directly regulated in the EU. CRAs are currently monitored by CESR for their self-regulatory compliance with the IOSCO Code of Conduct. CESR reports the findings annually to the European Commission.

In addition, the Capital Requirements Directive (CRD) outlines a formal process for supervisory recognition of rating agencies as "External Credit Assessment Institutions" (ECAIs) where banks wish to make use of external ratings for the calculation of capital requirements. To ensure consistent application of the ECAI recognition criteria CEBS has produced "Guidelines on the recognition of external credit institutions" which cover the recognition process; implementation of the CRD recognition criteria; and criteria for mapping external credit assessments to the CRD risk weights.

European Commission proposal for a Regulation on Credit Rating Agencies

On 12 November 2008 the European Commission put forward a legislative proposal for a Regulation on CRAs*, which lays down the rules designed to ensure high quality credit ratings. The proposed Regulation is partially inspired by the IOSCO code and includes the following features:

- CRAs may not provide advisory services;
- CRAs will not be allowed to rate financial instruments if they do not have sufficient quality information to base their ratings on;
- They must disclose the models, methodologies and key assumptions on which they base their ratings;
- They will be obliged to publish an annual transparency report;
- They will have to create an internal function to review the quality of their ratings;
- Prescriptive requirements for independent board directors;
- A rotation mechanism for analysts restricting the duration of the relationship with an issuer;
- CESR is given a powerful role, being the single point of entry for registration, but home Member State Regulators (of CRA subsidiaries in the EU) coordinate the ongoing supervision. One of those home Member State regulators would act as "facilitator";
- In order for a CRA to operate within the EU, it must act through an EU incorporated legal entity which has to be registered in the EU. In case of groups each separate EU incorporated legal entity subsidiary must register;
- The scope of the Regulation is stated to limit the use of credit ratings for regulatory purposes or otherwise. EU-regulated financial institutions may only use credit ratings issued by CRAs established in the EU and duly registered (consequently even highly rated non-EU securities are likely to be treated as unrated for EU regulatory purposes);

* http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf

- MiFID-authorized firms are prohibited from executing orders on rated financial instruments, if such ratings are not provided by a duly registered CRA (thus investors will be forced to execute trades in such instruments through non MiFID brokers);
- CRAs must publish a description of how rating methodologies differ for structured finance instruments or adopt a clearly differentiated rating category; and
- The independence of the analytical content of ratings is explicitly protected (though the inclusion of methodology in this protection of independence is only found in the recitals).

It should be noted that this proposal is framed as a Regulation rather than a Directive and hence will become effective without requiring to be transcribed into Member State law.

Developments since publication of the Draft Regulation

Industry participants have detailed a number of concerns and suggested amendments. These can be usefully viewed as an attempt to address the following more general concerns:

Extraterritoriality

Extraterritoriality concerns arise from Article 4 by which the EU would exercise global control over the credit ratings industry. As currently drafted EU regulated financial institutions could not make use of non-EU incorporated CRAs for regulatory purposes, even where currently non-EU incorporated CRAs are recognized as ECAI. Furthermore, European investors will be substantially limited in their flexibility to invest in regional (e.g. Asian) securities that are rated by local CRAs that lack the resources or desire to establish an EU-registered subsidiary. This will impede those emerging markets which are seeking to develop credible and effective local CRAs. At the same time, the measure places a nearly impossible compliance duty on MiFID-authorized firms.

Global consistency and coordination

Global consistency and coordination are critical for users of credit ratings operating in a global market. As recognized by the G20, it is important that regulatory frameworks across markets yield ratings that are the product of consistent global standards. Creating, within the regulation, an express role and framework for global communication and coordination, could support global consistency – in particular given established international standards and cooperation through IOSCO.

Market disruption

Market disruption can be anticipated upon inception of the Regulation. This will also be so in case of requiring CRAs to withdraw an existing rating, (as is provided for in certain circumstances) thereby forcing institutional investors with applicably defined mandates, or subject to capital adequacy /solvency requirements, to divest unrated securities. Current markets are not well-positioned to weather such disruptions.

Allocation of regional and sectoral authority

Allocation of regional and sectoral authority between CESR, 'home states' (any Member State in which a CRA has a subsidiary), a 'facilitator' (the 'home state' which coordinates CRA group oversight), and 'host states' (Member States in which a rating issued by a CRA is used) is loosely-defined and creates a potential for conflict arising out of uncoordinated, unilateral action. The regulatory landscape is further complicated by the existence of EU legislation targeted at the use of ratings for regulatory purposes. Furthermore the need for coordination with CEBS's and CEIOPS's is not adequately reflected.

Potential liability for opinions

While it is fully recognised that CRAs should be held accountable in the event of established breaches of their regulatory obligations, moves to make CRAs and their analysts legally liable for their opinions raise a very worrying precedent and directly undermine analytical independence. Quality of ratings would suffer as CRAs would potentially take a more conservative approach with analysts mindful of legal exposure.

By the end of 2008 the French Presidency had tabled a compromise text that addresses some of these concerns. The incoming Czech Presidency has made completion of the work on the CRA Regulation one of the priorities for its term. It has immediately started soliciting Member State opinion on various possible policy options and continues to lead forward discussion of these in the applicable Council Working Group. One significant example of such further work is the examination of a possible equivalence regime, to alleviate the continued concern over the extraterritorial effect of Article 4.

Conclusion

Whilst there are already various elements of existing supervision relating to CRAs the need for further regulation to address identified concerns is broadly accepted. Legitimate concerns remain about the final form of the CRA Regulation and work to completion of this exercise will require diligence and care. In particular this should consider that structured finance ratings represent the primary area that led to concern, whilst the proposed response impacts all CRA ratings activity, with consequent impacts for rated entities and their securities, and the use of ratings by EU regulated financial institutions. The common goal for all involved needs to be the achievement of a practical outcome, that at the same time provides a robust basis upon which CRAs can regain a trusted and valued role in the eyes of other market participants.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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