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PUBLIC CONSULTATION ON

CREDIT RATING AGENCIES

Important comment: this document is a working document of the Commission services for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

CONTENTS

INTRODUCTION

Credit rating agencies (CRAs) play a significant role in today's financial markets. They issue creditworthiness opinions that help overcome the information asymmetry between those issuing debt instruments and those investing in these instruments. CRAs have a major impact on the financial markets. It is essential, therefore, that they consistently provide high-quality, independent and objective credit ratings.

For this purpose Regulation (EC) No 1060/2009 on credit rating agencies[1] (CRA Regulation) was adopted in 2009 to introduce mandatory registration and on-going supervision for all credit rating agencies operating in the European Union. The CRA Regulation, which will enter in full application on 7 December 2010[2], requires credit rating agencies to comply with rigorous rules of conduct in order to mitigate possible conflicts of interest, ensure high quality of ratings and sufficient transparency of ratings and the rating process. Furthermore, in order to establish an efficient supervision entrusting supervisory powers to the European Securities and Markets Authorities (ESMA) and increase transparency with regard to ratings of structured finance instruments, a legislative proposal amending the CRA Regulation[3] has been adopted by the European Commission. This is currently being negotiated in the European Parliament and the Council.

However, some issues related to credit rating activities have not been addressed in the CRA Regulation. Those issues relate to the risk of overreliance on credit ratings by financial market participants, the high degree of concentration in the credit rating sector, the civil liability of credit rating agencies and the remuneration models used by credit rating agencies. The CRA Regulation requires the European Commission to monitor these issues and make an assessment by end of 2012.[4] In addition, during the recent Euro debt crisis, credit rating agencies have again been exposed to further criticism with regard to sovereign debt. The question was raised whether the EU regulatory framework for credit rating agencies needs to be further strengthened in order to ensure further transparency and enhance the quality of sovereign debt ratings. Also, the idea of promoting the establishment of a European credit rating agency was put forward at a political level.

Against this background the European Commission issued on 2 June 2010 a Communication ("Regulating Financial Services for Sustainable Growth")[5] announcing that it would examine the above-mentioned issues in order to assess whether further regulatory measures are needed. Also at international level, the International Monetary Fund recently released a global financial stability report with a specific focus on sovereign debt ratings[6] and the Financial Stability Board (FSB) recently endorsed principles to reduce on financial institutions' reliance on CRA ratings.[7]

1 Regulation of the European Parliament and of the Council on credit rating agencies of 16 September 2009, OJ L 302 of 17.11.2009.

2 From that date European financial institutions, when using ratings for regulatory purposes may only use credit ratings issued in accordance with the CRA Regulation.

3 Proposal for a Regulation of the European Parliament and of the Council on Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, COM(2010) 289 final, 2.6.2010.

4 Article 39 (1) of the CRA Regulation.

5 Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank regulating financial services for sustainable growth, COM(2010) 301 final.

6 International Monetary Fund, World Economic and Financial Surveys Global Financial Stability Report, October 2010.

7 FSB Press Release of 20 October 2010 available at http://www.financialstabilityboard.org/press/pr_101020.pdf.

The purpose of this consultation paper is to put forward some policy ideas and orientations on specific issues and gather the views of market participants, regulators and other stakeholders on possible future initiatives to strengthen the EU regulatory framework for credit rating agencies.

This consultation paper is divided into the following sections:

- Measures to reduce overreliance on external credit ratings and increase disclosure by issuers of structured finance instruments in order to allow investors to carry out own due diligence on a well informed basis;

- Improvements to transparency, monitoring, methodology and process of sovereign debt ratings in EU;

- Measures to enhance competition among credit rating agencies such as introducing new players into the credit rating agency sector and lowering barriers to entry for new and existing credit rating agencies;

- Introducing a civil liability regime for CRAs;

- New measures to reduce conflicts of interest due to the "issuer-pays" model and preventing rating shopping.

It is to be noted that, where sections contain several suggested measures/policy orientations, the latter are not mutually exclusive.

This consultation is open until 07/01/2011. Responses should be addressed to *markt-consultations@ec.europa.eu*. The Commission Services will publish all responses received on the European Commission website unless confidentiality is specifically requested. For administrative purposes please clearly state, in the email text, the following information:

- Organisation's Name;

- If you are registered with the Commission as an "interest representative" (https://webgate.ec.europa.eu/transparency/regrin/welcome.do), your identification number;

- Relevant contact details; and

- Confirmation that you acknowledge that your response will be published.

1. OVERRELIANCE ON EXTERNAL CREDIT RATINGS

The recent sovereign debt crisis has renewed the concern that financial institutions and institutional investors may be relying too much on external ratings and do not carry out sufficient internal credit risk assessments (overreliance on external ratings). Mechanistic and parallel reliance on external ratings by market participants may lead to herding behavior[8]. This may happen when debt instruments, such as sovereign bonds, are downgraded below a certain threshold and many financial institutions and investors react to this rating action at the same time by selling off their debt instruments. Such behaviour increases volatility in the market and may cause a self sustaining downward spiral of the price of the debt instruments with potential negative effects for financial stability.

The problem of overreliance is currently being addressed at the European and international level. In the banking sector some steps have already been taken towards reducing reliance on ratings[9] and further steps have been proposed by the Basel Committee of Banking Supervision in a consultative document of December 2009.[10] In the asset management sector the recent overhaul of the UCITS directive has strengthened due diligence and internal management obligations for UCITS managers.[11] The ECB Governing Council has also recently reviewed the issues associated with over-reliance on credit ratings for the access to central bank liquidity. The ECB is reviewing the functioning of the Eurosystem credit assessment framework (ECAF) in an annual report.[12]

The efforts are two-pronged: firstly, they aim at clearly requiring financial firms to undertake their own due diligence and internal risk management rather than indiscriminately relying on external ratings. Secondly, references to ratings in the regulatory framework should be reconsidered in light of their potential to implicitly be regarded as a public endorsement of ratings and their potential to influence behaviour in an undesirable way, for instance due to sudden hikes in capital requirements resulting from rating downgrades.

At the international level the Financial Stability Board (FSB) recently endorsed principles to reduce authorities' and financial institutions' reliance on CRA ratings.[13]

Three areas have been identified where external ratings are currently widely used by market participants and where there is a potential risk of overreliance. The first area relates to the use of external credit ratings for the calculation of certain regulatory limits and capital requirements for financial institutions. Notably the Capital Requirements Directive explicitly envisages the use of external ratings for measuring capital requirements especially in the context of the standardised approach and for securitisations (point 1.1). Secondly, financial firms largely use external ratings for internal (credit/market) risk management purposes

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8 The risk of herd behaviour is amplified by the high concentration in the rating market (see Section 3 on possible measures to increase competition in the rating market)

9 An obligation for banks to undertake own due diligence regarding the underlying assets of securitisation exposures has been introduced in Article 122a of the Capital Requirement Directive (Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L 177, 30.06.2006).

10 Basel Committee on Banking Supervision, Consultative Document on strengthening the resilience of the banking sector. Available at http://www.bis.org/publ/bcbs164.htm.

11 Obligations for risk management: Article 51 of the UCITS Directive (Directive 2009/65/EC of 13 July 2009 OJ L 302/32, 17.11.2009) and Articles 38-44 of Directive 2010/43/EC. Due diligence requirements: Article 23 Directive 23 (4) Directive 200/43/EC.

12 The ECAF defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met.

13 FSB Press Release of 20 October 2010 available at http://www.financialstabilityboard.org/press/pr_101020.pdf.

(point 1.2). The third area refers to the reference to external ratings in investment policies and mandates of portfolio and asset managers (point 1.3).

In addition to the areas mentioned above, there are a limited number of other references to external ratings in EU financial legislation. A brief overview of these references is provided in Annex 1 of this document.[14]

Finally, in laws and regulations of Member States there are also a number of references to external ratings which are not required by EU legislation.[15] In June 2009, the Joint Forum[16] undertook a stocktaking on the use of credit ratings which showed the use of ratings in the national legal orders of many EU Member States.[17]

1.1. Reference to external ratings in regulatory capital frameworks for credit institutions, investment firms, insurance and reinsurance undertakings

In the banking sector the use of external ratings is explicitly envisaged by the Capital Requirements Directive[18] in the context of regulatory large exposure limits and capital requirements for credit institutions[19] and investment firms.[20] Generally, institutions[21] have the choice of either using external or, subject to supervisory approval and under the conditions set out in the Capital Requirements Directive, their own internal credit ratings for those purposes, combined with a certain incentive to develop and use internal ratings.[22] However, in the context of regulatory large exposure limits and capital requirements for securitisation positions, institutions are implicitly required to use in certain instances external ratings to the extent they are available.[23]

14 See also in this respect the first consultation of DG MARKT of 31.07.2008 "Tackling the problem of excessive reliance on ratings", http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

15 For instance, some Member States' national laws implementing the investment rules of the Solvency I framework for the supervision of insurance undertakings (Articles 22 to 26 of Directive 2002/83/EC of 5 November 2002, OJ L 345, 19.12.2002, and Articles 20 to 23 of Directive 92/49/EEC of 18 June 1992, OJ L 228, 11.8.92) refer or place reliance on external ratings in order to determine whether a certain asset is eligible to cover technical provisions.

16 The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors.

17 The Joint Forum, Stocktaking on the use of credit ratings, June 2009. Available at http://www.bis.org/publ/joint22.pdf.

18 Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L 177, 30.06.2006.

19 Credit institutions as defined in Article 4 (1) of Directive 2006/48/EC.

20 Investment firms as defined in Article 4 (1) 1 of Directive 2004/39/EC.

21 'Institutions' comprises credit institutions and investment firms.

22 See Articles 78 and 84 in connection with Annex VII of Directive 2006/48/EC.

23 See Articles 96 and 113 of Directive 2006/48/EC. In principle, credit institutions have the choice to treat their securitisation exposures as unrated. This however leads to prohibitively high capital charges unless the credit institution uses internal ratings and is able to internally rate every single underlying loan of the securitisation.

In the insurance sector, the existing framework of insurance[24] and reinsurance[25] directives (commonly referred to as "Solvency I") does not contain any reference to external ratings as there is no explicit credit risk charge for the solvency margin. The same is true for the "Solvency II" Framework Directive[26] which has revised the existing solvency regime and introduced risk-oriented solvency requirements for insurance and reinsurance undertakings.[27] Capital requirements are calculated using a standard formula or, subject to supervisory approval, by the undertaking's internal model. The precise design of the standard formula capital requirements, including the market risk module and the counterparty default risk module, will be set out in the future implementing measures, which are currently being developed. In the fifth Quantitative Impact Study (QIS5)[28], which is currently being carried out, external credit ratings are used for the calculation of the standard formula, but QIS5 technical specifications do not prejudge any final decision as regards the final design of the standard formula.

The explicit reference to external credit ratings in regulatory capital frameworks raises concerns as it may give the impression to firms that external ratings are officially approved and can by implication be fully relied upon.

Completely eliminating any reference to external ratings in capital requirement frameworks does not seem to be a realistic solution, as long as there are no other alternative measures of credit risk which could be used instead by all financial firms (independent of their size, sophistication and the scale and complexity of the credit risk they are exposed to). A proportionate approach should therefore take into account the sophistication and capacity of firms to develop internal models for the calculation of capital requirements, as well as the extent to which the firm is exposed to credit risk.

More specifically, the following alternative ways to reduce the risk of overreliance could be considered:

(1) Larger and more sophisticated institutions (or networks of smaller institutions) and insurance and reinsurance undertakings could be required to use internal models for the calculation of capital requirements for credit risk.[29] In deciding which firms should be

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24 Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, OJ L 345/1, 19.12.2002. First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance OJ L 228,16.8.1973; Council Directive 78/473/EEC of 30 May 1978 on the coordination of laws, regulations and administrative provisions relating to Community co-insurance OJ L151, 7.6.1978; Council Directive 87/344/EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance OJ L 185 4.7.1987, p.77; Second Council Directive 88/357/EEC of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services OJ L 172, 4.7.1988 p.1; Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance (third non-life insurance Directive) OJ L 228, 11.8.1992.

25 Directive 2005/68EC of the European Parliament and of the Council of 16 November 2005 on reinsurance, OJ L 323/1, 9.12.2005.

26 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) , OJ L 335, 17.12.2009.

27 As defined in Art. 13 (1), respectively Art. 13 (4) of the Solvency II Framework directive.

28 In order to assess its impact the development of Solvency II is accompanied by five Quantitative Impact Studies. In these studies insurance and reinsurance undertakings as well as insurance groups under the scope of Solvency II determine their eligible own funds and capital requirements according to preliminary specifications of the new rules.

29 In the banking sector such institutions would be required to use the Internal Ratings Based Approach (IRBA) according to Article 84 and Annex VII of Directive 2006/48/EC. IRBA is an approach under which

obliged to use internal models account should be taken of the nature, scale and complexity of the credit risk a firm is exposed to. It should also be considered whether credit risk is the main source of risk to which a firm is exposed to. While the use of internal models would reduce the reliance on external credit ratings, it should also be considered that internal models are not an objective measure of risk and there is concern about the prudential and level playing field implications should the use of internal models be mandated by regulation. However, those concerns can be mitigated by enacting parameters prescribed in regulation and/or a rigorous supervisory approval process.

(2) Approaches that refer to external ratings for the calculation of capital requirements should be reviewed in order to reduce the reliance placed on credit ratings issued by an individual credit rating agency. This could be done by requiring firms to use at least two external ratings issued by different credit rating agencies and to consider the exposure as unrated unless at least two external ratings exist. This would base the calculation of capital requirements on a broader basis as at least the opinion of two independent rating agencies would flow into the calculation of capital requirements. Using a second rating opinion may lead to a more accurate assessment of the credit risk involved.

(3) Instead or in addition to referring to external credit ratings, regulatory capital frameworks could refer to other measures of credit risk such as market data (market expectation of default as reflected in bond prices, Credit Default Swap spreads) or regarding regulated counterparties, capital/solvency ratios (or a combination of indicators). The advantage of such an approach would be that the calculation of capital requirements would be based on different types of risk indicators and not exclusively on external credit ratings. Using market prices could however raise concerns as to possible pro-cyclical effects: price movements would immediately translate into higher capital requirements which could exacerbate volatility in the market; external ratings are in tendency less volatile and lead to more stable capital requirements.

(4) For securitisation exposures, institutions/insurance or reinsurance undertakings could be required to base their capital requirement on an analysis of the credit risk of the underlying pool. In the banking sector this could be achieved by requiring for securitisation exposures the use of the "supervisory formula" based approach[30] for any newly incurred securitisation exposure of an institution that has the authorisation to use the internal ratings based approach for the relevant exposure class. In the insurance sector a similar approach that was based on a look-through to the underlying pool has been used in the QIS5.[31] The bank should provide the relevant information to the investor with respect to the underlying pool. Accordingly, those investing institutions would be required to internally rate all individual exposures in the underlying pool and would be unable to invest in securitisations as long as they cannot meet this requirement.[32] It should be noted that this approach may restrict the potential investor base for

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a bank can be authorised to use its internal rating system to estimate certain risk parameters of loans. A standardised formula prescribed in legislation is then used to calculate the capital requirement based on the bank's parameter estimates. In the insurance sector the ability to use internal models is foreseen in Art. 119 of Directive 2009/138/EC.

[30] The "supervisory formula" is an approach that currently is allowed when a securitisation exposure is not externally rated but the bank is able to use its Internal Ratings Based Approach to calculate the hypothetical capital requirement for all individual underlying loans. A standardised formula prescribed in legislation is then used to derive capital requirements for the different tranches of the securitisation from the hypothetical capital required for its underlying loans (see Annex IX, part 4 point 52 of Directive 2006/48/EC).

[31] See paragraphs SCR.5.91 to SCR.5.97 of the QIS5 technical specifications, published on http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm.

[32] Rather than requiring internal ratings for all underlying exposures, an alternative could be to allow some internally unrated exposures in the pool (for instance up to 5% of the pools risk weighted assets) subject to a 150% risk weight.

securitisations, as some institutions that currently invest in securitisations may not be in a position to internally rate all underlying assets in the pool. Possibly, the methodology of the "supervisory formula" or similar approaches will have to be improved if they become more important in the regulatory framework.

(5) Require institutions and insurance/reinsurance undertakings using a "standardised approach" based on external ratings for calculating their regulatory capital requirements, to assess if the inherent credit risk of a – rated or unrated – exposure is significantly higher than the one that corresponds to the capital requirement assigned under the "standardised approach", and require them to reflect the higher degree of credit risk in the evalution of their overall capital adequacy. As mentioned above, less sophisticated firms should not be expected to develop internal capital models, but should be able, based on their internal credit granting criteria, to rank order credit risks. They could be required to assign appropriately higher capital requirements if the capital charges assigned under the "standardised approach" contradict the internal rank ordering of risks.[33]

Questions 1-6:

(1) Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?

(2) How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?

(3) Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?

(4) What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?

(5) Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed? To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?

(6) Can the existing "supervisory formula" based approach in the Capital Requirements Directive be considered to be sufficiently risk sensitive to become the standard for all securitisation capital requirements? If not,

[33] For instance, if an exposure assigned a 20% risk weight ranks in the internal assessment more in line with other exposures of the same exposure class that are assigned a 50% risk weight, the firm could be obliged to consider calculating its internal assessment of capital adequacy based on the 50% risk weight

how could its risk sensitivity be improved without placing reliance on institutions' internal estimates other than default probability and loss for the underlying exposures? In the insurance sector, how do you assess the approach to credit risk for structured exposures used in QIS 5?

1.2. Use of external ratings for internal risk management purposes

Regulated financial firms (credit institutions, investment firms, insurance and reinsurance undertakings, pension funds[34] and UCITS managers[35] and in the future alternative investment fund managers[36]) are required under EU legislation to have an effective risk-management system in place in order to identify, measure and monitor credit and investment risk.[37] While unlike the regulatory capital framework for institutions discussed above, the respective provisions in EU legislation on internal risk management neither require the use of external ratings nor refer to them in any other way, they do not explicitely exclude that firms may rely on external credit ratings in full or part for the purpose of their internal risk management.

In order to reduce the risk of overreliance in this respect and oblige regulated financial firms to individually assess the credit risk of assets they are investing in, the following measures could be considered:

(1) Explicitly obliging regulated financial firms not to rely exclusively and mechanistically on external ratings but to carry out their own due diligence and credit risk assessments.[38] A

[34] Institutions for occupational retirement provisions as defined in Article 6 of Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235/10.

[35] As defined in Article 2 of the UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, OJ L 302/32, 17.11.2009).

[36] Commission proposal for a directive on alternative investment fund managers of 30.04.2009, COM (2009) 207

[37] With regard to credit institutions this is stated in Annex V point 3 of Directive 2006/48/EC.
Regarding investment firms see Article 13 (5) Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ L 145/1, 30.4.2004) in connection with Article 7 of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006.
With regard to insurance and reinsurance undertakings see Article 44 of Directive 2009/138/EC; corresponding provisions exist in current legislation on supervision of insurance and reinsurance undertakings.
Regarding UCITS management companies and UCITS investment companies see Article 51 of Directive 2009/65/EC, Chapter VI of Directive 2010/43/EU.
Regarding alternative investment fund managers see Article 11 of the Commission proposal for a directive on alternative investment fund managers of 30.04.2009.

[38] Some recent regulatory changes in the Community legal framework are already going in this direction. The recent overhaul of the UCITS Directive (2009/65/EC) has strengthened due diligence and internal risk management requirements for UCITS managers (Article 51 of the UCITS Directive and Articles 23 and 38-44 of Directive 2010/43/EC). UCITS managers are obliged to ensure a high level of due diligence in the selection and ongoing monitoring of investments and to have adequate knowledge and understanding of assets. They should be able to formulate forecasts and perform analysis concerning the investment's contribution to a UCITS portfolio before carrying out the investment. These requirements aim at limiting automatic reactions of UCITS managers to external rating changes and may thereby limit the risk of overreliance. The obligation for banks to undertake own due diligence regarding the underlying assets of securitization exposures that has been introduced in Article 122a of the Capital Requirement Directive is another example.

clarification in this respect could be introduced in financial sectoral legislation.[39] Supervisors could focus on the process of verification of due diligence and risk management processes at the authorisation stage and on an ongoing basis whether there is an appropriate credit assessment process in place which does not exclusively rely on external ratings.

(2) In order to enable regulated financial firms to perform their own credit risk assessments, they need to have access to all of the necessary information. At the moment this is not the case, especially not for structured financial instruments, where information on the underlying assets of the pool is often only disclosed to the hired credit rating agency. The legislative proposal on amending the CRA Regulation issued by the European Commission on 2 June 2010[40] is a first step in this direction.

(3) Improved disclosure might also help smaller or less sophisticated firms. However, not all of them may have the ressources and expertise to carry out comprehensive internal assessments for all of the assets in which they invest and will therefore use, to a certain degree, external ratings. Supervisors should make sure that such firms provide for a proportionate internal risk assessment which takes into account the complexity of the assets they invest in. Supervisors should also ensure that such firms show supervisors that they have understood the methodologies of the credit ratings agencies whose ratings they use.

(4) Regulated financial firms could be required to formulate and publish an internal policy on their internal assessment of credit risk using a mix of risk measures. For example, they could (in addition to external ratings) base their internal credit risk assessment on private information obtained through due diligence, publicly available information, external research, market based measures and prices (such as bond prices, CDS spreads) or, regarding regulated counterparties, capital/solvency ratios. The use of internal models for credit risk management purposes should be promoted.

(5) It has been argued that sovereign-risk ratings are primarily based on publicly available information (including public debt, budget deficit, GDP growth prospects, per capita income, political risk etc) and therefore credit rating agencies would not have advanced knowledge compared to other financial market participants in this asset class (differently from ratings of corporate debt and structured finance). Such circumstances could justify requiring regulated financial firms to always carry out an internal credit assessment of sovereign debt and not to rely on external ratings for sovereign debt.

Questions 7-11:

(7) Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?

(8) What information should be disclosed to supervisors in order to enable them to monitor the internal risk management processes of firms with particular focus on the use of external credit ratings in these processes?

[39] Credit Institutions see Annex V point 3 of Directive 2006/48/EC; Investment firms see Article 13 (5) Directive 2004/39/EC and Article 7 of Commission Directive 2006/73/EC; Insurance and reinsurance undertakings see Article 44 of Directive 2009/138/EC.

[40] Articles 8a and 8b of the European Commission Proposal on amending Regulation (EC) No 1060/2009 on credit rating agencies of 2 June 2010, COM (2010) 289 final. The proposal introduces an obligation on issuers of structured finance instruments to provide access to the information they give to the credit rating agency they have appointed, to all other interested credit rating agencies.

(9) To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in their investment policies, risk management processes and in investment mandates?

(10) What further measures, in addition to the disclosure proposals included in Articles 8a and 8b[41] of the proposal amending the current CRA Regulation could be envisaged?

(11) Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?

1.3. Use of external ratings in the mandates and investment policies of investment managers[42]

Investment mandates and investment policies often make reference to external ratings to define the minimum standard of credit quality for a portfolio. External ratings are also used in the definition of performance benchmarks. Indeed, investors often require investment managers to adhere to minimum credit quality standards, defined in terms of external ratings. This provides a relatively simple and transparent mechanism for investors to control and monitor the credit risks associated with the assets in which the manager invests.

While this use of credit ratings is not a direct consequence of the regulation of investment managers– the UCITS Directive, for example, does not mandate the use of external ratings in credit risk assessment[43] –, the widespread use of thresholds expressed in terms of external ratings in investment policies and mandates may exacerbate the "cliff effects" associated with rating downgrades. Investment managers will be obliged to sell off financial instruments which no longer comply with the credit quality standards specified in their mandate or policy. The simultaneous selling of debt instruments triggered by a downgrade may result in losses to investors and increase volatility in the market. Another "cliff effect" may occur when debt instruments which are downgraded below a certain threshold are removed from bond market indices which serve as a benchmark for portfolios.

In order to address these issues, the following measures could be considered:

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[41] Articles 8a and 8b of the European Commission Proposal on amending Regulation (EC) No 1060/2009 on credit rating agencies of 2 June 2010, COM (2010) 289 final. The proposal introduces an obligation on issuers of structured finance instruments to provide access to the information they give to the credit rating agency they have appointed, to all other interested credit rating agencies.

[42] This comprises persons that manage assets on behalf of others, either as UCITS management companies and UCITS investment companies as defined in directive 2009/65/EC (UCITS Directive) or as portfolio managers through a discretionary mandate from an individual client, according to Article 4 (1) 9, Annex 1 A (4) of Directive 2004/39/EC (MiFID).

[43] Only Article 6(1)(3) of Directive 2007/16/EC refers to investment rate grading as one of non-cumulative criteria for the purpose of definition of eligible assets for UCITS (see annex 1 for details). However explicit references to ratings may be a feature of national regulatory regimes for investment funds. The recently adopted CESR Guidelines on a common definition of European money market funds of 19 May 2010, CESR/10-049 also refer to credit ratings in determining whether a fund can be classified as a money market fund or short-term money market fund. See details in the Annex 1.

(1) Requiring investment managers to regularly review the use of external ratings in their investment guidelines and mandates. Regular reviews would raise the awareness of investment managers and investors to the risk of having external rating triggers in investment mandates and policies. The aim would be to reduce the use of automatic rating triggers and to introduce some flexibility which would allow investment managers to deviate from external rating thresholds under specific conditions.

(2) Incentivising investment managers and investors to minimise references to external ratings in investment policies and mandates. In order to do so, it should be explored what alternative measures of credit risk could be used in order to define the minimum standard of credit quality for a portfolio or as a benchmark for investment policies. Alternative measures for credit risk could include internal ratings or rolling averages of market prices (bonds, CDS spreads).

(3) Requiring investment managers to apply measures (e.g. internal limits) which ensure that only a proportion of the portfolios managed by them is reliant on external credit ratings. Investment managers would have to carry out an individual credit risk assessment for a defined proportion of their portfolio. Account should be taken of the fact that especially smaller or less sophisticated investment managers may not have the resources and expertise to carry out comprehensive internal assessments for all of the assets in which they invest and may therefore need to rely to a certain extent on external ratings. The proportion of investment managers' portfolios for which they have to provide an individual risk assessment could be gradually increased over time.

<u>Questions 12-15:</u>

(12) Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?

(13) Should investment managers be obliged to introduce measures to ensure that the proportion of portfolios that is solely reliant on external credit ratings is limited? If yes, what limitations could be considered appropriate? Should such limitation be phased in over time?

(14) What alternative measures of credit risk could be used to define the minimum standard of credit quality for a portfolio? Are rolling averages of bond prices/CDS spreads a suitable risk measure for this purpose?

(15) What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates?

2. SOVEREIGN DEBT RATINGS

In the context of the recent Euro debt crisis, credit rating agencies have been criticised for having adapted the credit ratings of certain Eurozone Member States too slowly to the deterioration of their public finances and, subsequently, for having overreacted in the downgrading actions, without for instance taking due account of supportive measures of the Eurozone Member States. In addition, doubts have been raised on the appropriateness of the methodologies and models used by credit rating agencies to rate sovereign debt. Enhanced transparency in the rating process for sovereign debt has also been advocated. Moreover, questions have been raised as to whether credit rating agencies have sufficient and adequate staff in place to effectively and efficiently monitor and update sovereign debt ratings. Finally, some countries have raised concerns about the timing of rating publications.

It is clear that sovereign debt ratings play a crucial role for the rated countries, since a downgrading has the immediate effect of making a country's borrowing more expensive. In an extreme scenario, a downgrading action can eventually bar a downgraded country from accessing external funding from international capital markets. Cliff effects[44] following a downgrading action induced by excessive reliance on sovereign debt ratings by financial institutions and institutional investors exacerbate the situation and may lead to a price deterioration of the sovereign bonds.

Moreover, a given level of sovereign ratings usually caps the rating accessible to the large majority of entities located in this country — including public administrations, local governments, public sector companies, and private firms. Consequently, a sovereign rating has an important impact on the magnitude, cost, and conditions of access to external funding for many other entities. This suggests that a sovereign downgrade has a significant bearing on the funding magnitude and quality at the macroeconomic level.

In a recent report[45], the International Monetary Fund highlighted a number of specificities of sovereign debt ratings. For instance, the small number of sovereign defaults which limits the amount of data available makes it more difficult than for other asset classes to develop rating models. Secondly, the rating of sovereign debt requires considerable subjective assessment from rating analysts, for instance when assessing a country's "willingness to pay".

Credit rating agencies' remuneration policies for sovereign debt ratings are not uniform. While most of the countries participate in the rating process, not all of them are charged for having their debt rated. The fact that many countries pay for the rating service they receive may raise concerns with regard to conflicts of interest inherent in the issuer-pays model.[46]

The current CRA Regulation already contains enacting provisions which aim to ensure the transparency of the rating process and the high quality of the ratings and rating methodologies.[47] Those rules fully apply to ratings of sovereign debt. Given the importance and specificities of sovereign debt ratings, it may however be justified to increase the level of transparency and add some specific procedural requirements that credit rating agencies have to comply with when rating sovereign debt. On the other hand, the principle that supervisory authorities and any other public authority should not interfere with the content of

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44 Cliff effects in this context are sudden actions that are triggered by a rating downgrade under a specific threshold. They may for instance occur if a specific sovereign debt is downgraded to non investment grade and following this downgrade many investment managers have to sell off this instrument as it does not correspond any more to their investment policies or mandates.

45 International Monetary Fund, World Economic and Financial Surveys Global Financial Stability Report, October 2010.

46 See also Section 5 of this paper.

47 Notably Articles 8 and 10-12 of the CRA Regulation.

credit ratings and methodologies[48] has to be respected. This principle is particularly important with regard to the rating of sovereign debt, in order to prevent conflicts of interest and guarantee the independence of the credit rating agencies.

2.1. Enhance transparency and monitoring of sovereign debt ratings

Given the importance and specificities of sovereign debt ratings, it is essential that ratings of this asset class are timely and transparent. While the rules of conduct, disclosure and transparency in the CRA Regulation already fully apply to the issue of sovereign debt ratings[49], the following measures could be considered to further strengthen transparency and quality, specifically for the rating of sovereign debt:

(1) Credit rating agencies could be obliged to inform the country for which they are in the process of issuing a rating at least three working days before the publication of the rating on the principle grounds on which the rating is based, in order to give the country the opportunity to draw the attention of the credit rating agency to any factual errors and to any new developments which may influence the rating. This extension of the time period which applies to the ratings of other entities, where a 12-hour period applies[50], may be justified due to the potentially severe consequences a downgrade may have on the rated country and financial stability, which makes it critical that any factual errors are avoided. However, an extension of the period from 12 hours to three days before the final rating is publicly disclosed may increase the risk of market abuse. In order to mitigate this risk, appropriate safeguards would have to be put in place, e.g. by limiting the number of persons that are informed about the content of the imminent rating action. This would not mean that the agreement of the rated country is required. Indeed, the country's authorities would have more time to draw the attention of the CRA to factual errors.

(2) In order to increase the transparency of a specific rating action, credit rating agencies could be obliged to disclose free of charge their full research reports on sovereign debt ratings. Under the current CRA Regulation, credit rating agencies are only obliged to explain in a press release or a report the key elements underlying their credit rating.[51] This additional information would enable investors to better understand the timing, extent and underlying reasons for a specific rating action and also enable them to make a better informed assessment. Better information for investors may contribute to a more balanced reaction by investors to a specific rating action.

(3) In order to make the allocation of staff to the different asset classes (corporate, structured finance instruments, sovereigns) more transparent and to increase market discipline, credit rating agencies could be required to disclose additional figures on the allocation of staff in their annual transparency report. Under the current framework credit rating agencies are already required to publish statistics on the

[48] Article 23 (2) of the CRA Regulation.

[49] For instance, a CRA is required to disclose all methodologies and models it uses (Annex I Section E.I.5) and has to explain each time it issues or updates a rating, on which methodology this rating has been based (Annex I Section D.I.2 b). A CRA has to indicate all material sources that it has used to prepare the rating (Annex I Sections D.I.2 a) and any limitations to the rating (Annex I Sections D.I.4) and the reasons triggering the rating action (Annex I Sections D.I.5).

[50] According to Article 10 in conjunction with Annex I, Section D I.3 of the CRA Regulation a credit rating agency shall inform the rated entity at least 12 hours before publication of the credit rating and of the principle grounds on which the rating is based in order to give the entity an opportunity to draw attention of the credit rating agency to any factual errors.

[51] Article 10 in conjunction with Annex I, Section D.5 of the CRA Regulation.

allocation of staff to new credit ratings, credit rating reviews, methodologies or model appraisal and senior management.[52] In addition to this, credit rating agencies could be required to publish the number of staff involved in the rating process for the different asset classes (corporate, structured finance, and sovereign), including the ratio of the number of issued/monitored ratings per analyst for each asset class.

(4) The maximum time period after which sovereign debt ratings have to be reviewed could be significantly reduced. Currently, Article 8 (5) of the CRA Regulation requires credit rating agencies to monitor and review credit ratings on an ongoing basis and at least annually. Reducing the time period to six months, after which credit rating agencies have to provide a full review of sovereign debt ratings would better ensure the continuity of sovereign debt ratings, reduce rating variances and enhance capital market stability.

Questions 16-18:

(16) What is your opinion regarding the ideas outlined above? How can the transparency and monitoring of sovereign debt ratings be improved?

(17) Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?

(18) Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?

2.2. Enhanced requirements on the methodology and the process of rating sovereign debt

The CRA Regulation sets out a number of qualitative requirements that rating methodologies (including on sovereign debt) must comply with, namely that they have to be rigorous, sound, continuous and subject to validation based on historical experience.[53] In addition, the credit rating agencies are required under the current framework to disclose the methodologies and models they use[54] and to explain each time they issue or update a rating which methodology was used in determining the rating.[55] Given the relevance of sovereign debt ratings, a number of further requirements could be considered to enhance sovereign debt rating methodologies, so as to ensure their appropriateness and to improve investors' understanding of and confidence in the rating process for sovereign debt. The following measures could be considered:

52 Article 11 in conjunction with section E.III.3 of the CRA Regulation.
53 Article 8 (3) of the CRA Regulation. On 30 August 2010 CESR has published guidance on common standards for the assessment of compliance of credit rating methodologies with the requirements set out in Article 8.3, Ref. CESR/10-945, available at http://www.cesr.eu/popup2.php?id=7116.
54 Annex I Section E I 5 of the CRA Regulation.
55 Annex I Section D I 2 b of the CRA Regulation.

(1) Similar to the requirement in the CRA Regulation which only applies to the rating of structured finance instruments[56], a credit rating agency issuing sovereign ratings could also be obliged to accompany the disclosure of methodologies, models and key rating assumptions with a detailed explanation of the assumptions, parameters, limits and uncertainties surrounding the models and methodologies used when establishing sovereign credit ratings. This would facilitate the understanding of methodologies and models by investors and enable them to critically assess the rating process used by the credit rating agency.

(2) Under the CRA Regulation, credit rating agencies have the obligation to disclose their methodologies and a description of models and key rating assumptions used in their credit rating activities.[57] In addition to this obligation, credit rating agencies could be obliged to hold regular (e.g. semi-annual) meetings where they present and discuss their methodologies on sovereign debt ratings and which would be open to all interested parties (rated countries, financial institutions, and other users of ratings). Alternatively, credit rating agencies could be obliged to set up a mail box where all interested parties, including the rated countries and users of ratings, could send any questions they may have related to sovereign rating methodologies. Questions and answers could be published on the agency's website. These measures could increase the transparency of the rating process for sovereign debt and promote the involvement of stakeholders in the rating process.

(3) Article 10 of the CRA Regulation provides that a credit rating agency shall disclose any rating on a non-selective basis and in a timely manner. A further requirement could be imposed to specify that credit rating agencies should publish sovereign debt ratings only after the close of business of European trading venues. This would reduce the risk of high intra-day volatility, which often occurs when significant rating actions on sovereign debt ratings are published during trading hours. Delaying the publication until the close of business on the day when the rating was finalised would not significantly enhance the risk of market abuse and would still constitute timely information for investors. As an alternative, the credit rating agency could be required to discuss the timing of the publication of the rating with each rated country individually and to consider any relevant concern a country may have regarding specific publication dates or times.

(4) Most of the EU Member States provide information to the rating agencies in the context of the sovereign debt rating process. However, there is no uniform approach regarding credit rating agencies' remuneration policies for the issue of sovereign debt ratings. Presently, although almost all EU Member States are participating in the rating process, not all of them pay the credit rating agencies for providing sovereign debt ratings. In order to mitigate potential conflicts of interest inherent in the issuer pays model, one option would be for EU Member States not to pay for the ratings of their sovereign debt. Member States would still participate in the rating process, but they would not pay for the rating service. Credit rating agencies use the ratings of sovereign debt as a necessary element for the rating of other entities based in that country and therefore have a genuine interest to rate sovereign debt.

Questions 19-22:

(19) What is your opinion on the need to introduce one or more the proposed measures?

[56] Annex I Section D II 3 of the CRA Regulation.
[57] Annex I, Section E I 5.

(20) More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?

(21) Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?

(22) What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

3. ENHANCING COMPETITION IN THE CREDIT RATING INDUSTRY

The credit rating agency sector can be seen as oligopolistic in nature as it is characterised by the presence of only a few large firms and shows high barriers to entry in terms of reputation and high start up costs. In particular, concerns have been expressed that the rating of large multinational entities and structured finance products is concentrated in the hands of the three largest credit rating agencies, which may lead to a low degree of competition and negatively impact the quality of credit ratings.

It is possible that competition in the credit rating agency sector could be enhanced by introducing substitutes for credit ratings as noted in Section 1 above. In addition, competition might also be enhanced by introducing new players into the market and/or by lowering barriers to entry or expansion for new and existing credit rating agencies.

However, in attempting to stimulate competition in this sector, it is important to ensure that any measures to be adopted are carefully monitored so as not to create undue distortions of competition or lead to a decrease in the quality of credit ratings.

In the course of the CRA Regulation discussion with the European Parliament, the issue of the creation of a new independent, preferably European, credit rating agency was raised. This aspect was reflected in one recital[58], which states that the European Commission should submit a report to the European Parliament and the Council by December 2012 assessing the reliance on credit ratings in the EU, the appropriateness of the remuneration of the credit rating agencies by the rated entities (the "issuer-pays" model), including the assessment of the creation of a public EU credit rating agency. Both the European sovereign debt crisis and the way credit rating agencies have dealt with the situation have revived the interest for the idea.

Moreover, any initiative to create an independent credit rating agency to rate sovereign debt has to be carefully assessed, as the same strict conditions to be applied by CRAs under the CRA Regulation should apply, in particular the rules on conflicts of interest. The CRA Regulation imposes the condition that central banks cannot issue ratings concerning financial instruments issued by the central banks' Member States.[59]

The CRA Regulation could facilitate the entry of new players in the credit rating agency sector, as the registration requirements imposed on credit rating agencies are expected to enhance public confidence in a credit rating agency's capability to issue quality credit ratings. This could help new market entrants to overcome the reputational barrier to entry or help existing agencies to expand the scope of their ratings activities.

In order to enhance competition in the credit rating industry several possibilities could be explored. The ECB or National Central Banks could be encouraged to issue credit ratings, new market entrance could be encouraged by Member States at national level or a new EU based credit rating agency could be created using either public or private funding or a combination of both.

3.1. European Central Bank or National Central Banks

The European Central Bank (ECB) or National Central Banks (NCBs), whether or not participating in the European system of central banks, could be entrusted with the task of issuing ratings to be used for regulatory purposes by European financial institutions.

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58 See also recital 73 of the Regulation.

59 Article 2 (2) d, (3) of CRA Regulation.

Currently, in the assessment of the credit standard of eligible assets[60], the ECB Eurosystem takes into account credit assessment information from credit assessment systems belonging to one of four sources, namely external credit assessment institutions (ECAIs), national central banks' in-house credit assessment systems (ICASs)[61], and counterparties' internal ratings based (IRB) systems or third-party providers' rating tools (RTs).

Presently, there are four National Central Banks[62] which apply in-house credit assessment systems and form an official source to ICASs as defined by Eurosystem.[63]

There may be scope to further develop in-house credit assessment systems and consider whether national Central Banks could build up sufficient knowledge and capacity to produce the relevant in-house credit rating services which could be developed to compete with external credit rating agencies. In terms of the registration and supervision of rating activities, the CRA Regulation already envisages the possibility that the European Commission exempts[64] central banks from the registration process and ongoing supervision by the competent authorities, although they cannot rate sovereign debt concerning their country.

It is also important to note that because of the ECB and National Central Banks independence, any move towards the suggested approaches would need to be done on voluntary basis.

3.2. New National Entrants

It is not for policy makers to decide on business opportunities and whether certain activities are commercially viable or not. Nevertheless, Member States could be encouraged to explore ways of enhancing competition, inter alia through the creation of new credit rating agencies at national level as either public or private entities to help stimulate competition in the credit rating agency sector. Any such entity would also be subject to the registration and operational requirements set out in the CRA Regulation.

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60 Chapter 6 of General Documentation on Eurosystem Monetary Policy Instruments and Procedures. See The Implementation of Monetary Policy in the Euro Area, European Central Bank, Eurozone, November 2008, page 34. Available from http://www.ecb.int/pub/pdf/other/gendoc2008en.pdf.

61 In house Credit Assessment Systems and Credit Registers allow Central Banks to address many areas of responsibility. In particular, in-house credit assessment systems are used by Central Banks for credit risk assessment of companies. The main objectives are: 1) ensure good banking supervision and evaluation of financial stability; 2) assess the quality of credit collateral. ICAS are not subject to the CRA Regulation.

62 Deutsche Bundesbank, Banco de España, Banque de France, and Oesterreichische Nationalbank. See the ECB, NCB in-house credit assessment system source. Available from http://www.ecb.int/paym/coll/elisss/icas/html/index.en.html.

63 General Documentation on Eurosystem Monetary Policy Instruments and Procedures, The Implementation of Monetary Policy in the Euro Area, European Central Bank, Eurozone, November 2008, p. 46. Available from http://www.ecb.int/pub/pdf/other/gendoc2008en.pdf.

64 Exemption is given if: (i) the credit ratings produced by the central bank are not paid for by the rated entity; (ii) the credit ratings produced by the central bank are not disclosed to the public; (iii) the credit ratings produced by the central bank are issued in accordance with the principles, standards and procedures which ensure the adequate integrity and independence of credit rating activities as provided for by the Regulation; and (iv) the credit ratings produced by the central bank do not relate to financial instruments issued by the respective central banks' Member States. CRA Regulation: Article 2 (2) d, (3). For instance, the exemption was granted to Banque de France which is providing rating activities. See exemption decision: (EC) No 1060/2009, C(2010) 3853, OJ L 154, 19.06.2010.

Small and Medium Sized credit rating agencies created at national level could possibly seek State aid from Member States to help cover their start up costs or generate risk capital.[65]

3.3. Public/Private structures

The approach proposed below, brought forward as a solution by various sources, requires a particular assessment of the feasibility of such a structure. A public structure could potentially distort competition. The aim should be to avoid undue distortive consequences.

A new independent European Credit Rating Agency could be set up in a public/private structure such as an Institution "d'utilité publique", a Public Interest Company[66], a European foundation or a public-private partnership.[67]

The costs of establishing a new EU credit rating agency could be wholly or partially covered by the private sector. In order to ensure professional autonomy of its management and staff and, consequently its credibility, such entity should be independent. Public authorities' main role should be to ensure that the capital spending is assigned for the purposes for which it was created.

Subsidies could be provided through existing mechanisms by the European Investment Bank, the European Commission and Member States. Any initial public investment could then be phased out, ultimately allowing the new credit rating agency to become a purely private entity.

Alternatively, a new EU credit rating agency could conceivably be operated as a not for profit organisation, relying on revenues generated by its rating activities.

3.4. European Network of Small and Medium-sized Credit Rating Agencies

European small and medium-sized credit rating agencies could establish a European network of agencies. They could collaborate to create a common rating platform by sharing best practices and resources, building expert knowledge and enhancing the quality of ratings. Such a platform could offer an opportunity to improve competitiveness of individual small and medium-sized credit rating agency and allow them to expand into the rating of a wider range of entities or products, which would help provide credible

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[65] Handbook on Community State Aid Rules for SMEs, 25/02/2009. Available from http://ec.europa.eu/competition/state_aid/studies_reports/sme_handbook.pdf.

[66] Public Interest Companies have been introduced in a number of public services in the UK. Network Rail (the equivalent of the Swedish Banverket) was introduced in 2002, and is still one of the most well-known PICs. Other examples in include Glas Cymru (the Welsh water utility) and 'foundation hospitals' (the new structure for the British Primary Care Trusts). Some of these Public Interest Companies have been introduced by the British Labour government; some of them have come into being through private initiatives. Similar structures also exist in other EU Member States, for instance, "société anonyme d'intérêt public" in Belgium and "Stiftung des öffentlichen Rechts" in Germany.

[67] PPPs, COM(2009) 615. Available from http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0615:FIN:en:PDF.

European alternatives[68] to the services provided by the three major credit rating agencies.[69]

The small and medium-sized credit rating agencies forming such a network of agencies should remain independent legal entities[70] and would be subject to the current CRA Regulation.

It is not the role of the EU to decide on business opportunities and whether certain activities are commercially viable. Nevertheless, the EU could act as a promoter of such a network.

Questions 23-30:

(23) How could new players be encouraged to enter the credit rating agency sector?

(24) Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions? If yes, which asset classes (corporate, sovereign, structured finance instruments etc) could be considered?

(25) Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?

(26) Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level? How could such agencies be structured and funded and what entities and products should they rate? What are the potential advantages and disadvantages of this approach?

(27) Is there a need to create a new independent European Credit Rating Agency? If so, how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit rating agency? What are the potential advantages and disadvantages of this approach?

(28) Is further intervention needed to lower barriers to entry or expansion in the credit rating agency sector in general or as regards specific segments of the credit ratings business? What actions could be envisaged at EU and at Member State level?

68 Small and Medium-sized European credit rating agencies through effective cooperation could generate extra capacity, knowledge and resources to ensure also credit ratings of structured finance instruments and sovereign debt.

69 Fitch, Moody's and S&P.

70 The Network of Agencies cannot be registered under the CRA Regulation.

(29) Would the creation of a European Network of Small and Medium Sized Credit Rating Agencies help increase competition in the credit rating agency sector? What are the potential advantages and disadvantages of this approach?

(30) Do you consider that there are any further measures that could be adopted to enhance competition in the rating business?

4. CIVIL LIABILITY OF CREDIT RATING AGENCIES

The CRA Regulation does not regulate civil liability itself but states in Recital 69 that any claim against credit rating agencies in relation to any infringement of the provisions of this Regulation should be made in accordance with the applicable national law on civil liability.

Whether and under which conditions claims by investors against credit rating agencies are possible varies according to the legal order of each Member State.[71] These differences between Member States' civil liability regimes with regard to credit rating agencies could possibly result in forum shopping, when credit rating agencies or issuers choose jurisdictions under which civil liability for infringements of the CRA Regulation is less likely.

In order to ensure that credit rating agencies can be held liable for any damage directly caused to investors by an incorrect rating, the necessity of introducing a civil liability regime in the CRA Regulation could be considered:

(1) A specific provision on the civil liability of credit rating agencies could be introduced in the CRA Regulation according to which credit rating agencies could be held liable if they intentionally or negligently infringe the provisions of the CRA Regulation leading to an incorrect rating on which investors have based investment decision.

(2) Consideration could be given to the issue of whether this provision would only apply where a credit rating agency has given a higher than appropriate rating and an investor had chosen to invest, or if it should include situations where a credit rating agency has given a lower than appropriate rating and the investor had chosen not to invest.

(3) A civil liability regime could cover solicited as well as unsolicited ratings. While it is true that unsolicited ratings are in most cases based on publicly available information and conflicts of interests on the part of the credit rating agency are less pronounced, the obligations in the CRA Regulation also apply to the issuance of unsolicited ratings and their infringement may lead to incorrect ratings which may cause damage to investors who relied on them.

A specific liability regime for credit rating agencies at EU level as described above would improve legal certainty for investors, prevent forum shopping and have a preventive disciplining effect on credit rating agencies. It should also be noted in this context that the civil liability of credit rating agencies has been recently introduced in the US legal system by the Dodd-Frank Act.[72] Credit rating agencies have recently refused[73] to rate structured finance instruments in reaction to the reinforced liability rules.

<u>Questions 31-33:</u>

(31) Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?

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[71] One Member State has recently introduced a specific civil liability regime for CRAs, in other Member States there is ongoing discussion whether CRAs could be held liable vis a vis investors and in a third group of Member States civil liability of CRAs towards investors seems to be legally impossible.

[72] Dodd-Frank Wall Street Reform and Consumer Protection Act, 29 June, 2010. Available from http://financialservices.house.gov/FinancialSvcsDemMedia/file/key_issues/Financial_Regulatory_Reform/conference_report_FINAL.pdf.

[73] Financial Times, "Raters go on strike", 23 July, 2010.

(32)	**If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?**
(33)	**Should such a potential liability regime cover solicited as well as unsolicited ratings?**

5. POTENTIAL CONFLICTS OF INTEREST DUE TO THE "ISSUER-PAYS" MODEL

The CRA Regulation has introduced measures[74] to counteract the inherent conflicts of interest of the "issuer-pays" model which is the prevailing model among credit rating agencies.[75] This model relates to the case where issuers solicit and pay for the ratings of their own debt instruments.

Nevertheless, the "issuer-pays" model entails conflicts of interest by its nature. The inherent conflict of interest in this model is that rating agencies have a financial interest in generating business from the issuers that seek the rating, which could lead to assigning higher ratings than warranted in order to increase its revenues from the issuer. A low rating might affect future business. If reputational concerns or regulation are not strong enough to discipline credit rating agencies, the "issuer-pays" model can result in inflated ratings. A rating agency may choose a quality standard below the socially efficient level. In this case, a rating agency does not internalise the costs that investors suffer from investing in low-quality securities. A credit rating agency may give too favourable ratings to low quality securities in order to increase its revenues. Mandating that a rated entity enters in to a fixed term contract of several years with a credit rating agency may go some way towards addressing concerns about credit ratings being maintained at an artificially high level by agencies so as not to lose the business of the rated entity.

However, it does not seem that contractual restrictions can remove all of the outstanding issues surrounding conflicts of interest which have led to the consideration of alternative payment models in the credit rating market: the "investor/subscriber-pays"[76] and the "public utility/government" model.[77] Neither of these remuneration models is potentially free from conflicts of interest. There are different conflicts of interest: some investors may have an interest in lower ratings, for instance to cash in an insurance when the default occurs, while the governments/sponsors could place pressure to achieve higher ratings. Different remuneration models can co-exist in the same credit rating agency, and on the same market.

It has also been argued that under the "investor-pays" model there is the risk of "free-riders" and information leaks when an investor accesses the information paid by another investor, without having to support the cost of the information production. Some experts doubt whether the "investor-pays" model would provide enough resources for credit rating agencies to deliver high quality ratings and employ a sufficient number of analysts, as investors are not always prepared and/or willing to pay for rating services. Ultimately the "investor-pays" model could marginalise ratings for smaller issuers and less liquid issuances.

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74 For instance, credit rating agencies have to undertake all necessary steps to ensure that their ratings are not affected by any existing or potential conflict of interest (Art. 6 (1) of the CRA Regulation in conjunction with Annex I, Section B 1). They have to disclose to the public the names of the rated entities from which they receive more than 5 % of their annual income (Art 6 (2) in conjunction with Annex I Section B 2). Rating analysts may not be involved in any negotiation regarding fees with a rated entity and their remuneration shall not depend on the remuneration received from the rated entity (Art. 7 (2), (5) of the CRA Regulation). .

75 The CRA Regulation is neutral as to the remuneration model credit rating agencies may use. However, the "issuer pays" model is by far the dominant remuneration model currently used by credit rating agencies. On average, the revenue generated by "issuer-pays" model represents more than two-third of total CRAs revenues.

76 In which credit rating agencies would earn fees from users of the rating information.

77 A common understanding is that a "Public utility" model requires transforming the credit rating agency into a public utility and funding it with government revenues.

The "public utility/government" model also has disadvantages: it is not free from conflicts of interest (governments are rated entities); it could also negatively affect the financial markets and it is a costly proposition involving taxpayers' money.

Therefore as alternatives to the "Issuer-Pays" model, in addition to the measures already foreseen in the CRA Regulation, the potential distorting influence of a fee-paying issuer over the rating determination could be addressed in any of the following ways:

5.1. “Subscriber/Investor-Pays” model

The options described below could help stimulate competition between credit rating agencies. It could also give investors the opportunity to access more comparative information, and thereby improve confidence in and the stability of capital markets. The options are the following:

a. To avoid issuer domination of the rating process, institutional investors could be required to obtain their own ratings before they can purchase a particular financial instrument. The issuer could remain free to hire its own rating agency, but each institutional investor would need to obtain its own independent rating. Hence there would be two compulsory ratings: one paid for by the issuer, and a second paid for by the investor. In addition to these two ratings, all other competing credit rating agencies would be free to issue unsolicited ratings. The goal of this approach would be to spur the growth of a “subscriber-pays” rating market. Its key assumption is that a “subscriber-pays” rating market will not develop on its own (as it clearly has not done so to date) as long as investors are free to rely on "issuer-paid” ratings.

b. To mandate or encourage the formation of investor-owned credit rating agencies and investor-controlled rating agencies. These agencies could be owned and operated by the largest, most sophisticated debt market investors and could encourage the creation of sophisticated, well capitalised new market entrants with strong incentives to promote an investor's point of view in the rating process. Investor-owned credit rating agencies could be organised as for–profit or not-for-profit entities, and because they would be controlled by the investor community they would have powerful incentives to issue prudent, even sceptical ratings.

c. Groups of institutional investors could economise on their fees by jointly hiring an independent agency at a discounted "wholesale" price. The hired credit rating agency could undertake the unsolicited and independent ratings and to provide independent ratings to the investors. This option could have multiple advantages, firstly it could benefit capital markets by increasing investor confidence (i.e. an opportunity to have a double check on ratings) and, secondly, it could enhance competition in the credit rating business.

5.2. “Payment-upon-results” model

Given that credit ratings are forward looking by nature, the performance of credit ratings over time could be used to determine the level of fees the credit rating agencies may charge. An important part of the fees could be put into a fund, against which the credit rating agencies could borrow to finance their operations. Disclosure of these deferred contingent compensation schemes could be required, so that investors could decide for themselves which schemes provide adequate incentives. This measure could significantly increase investor confidence.

5.3. “Trading venues Pay” model

The "Issuer-Pays" model could be replaced with a model where trading venues pay for the ratings of their listed companies/instruments. In case of non-listed companies/instruments the "Subscriber/Investor Pays" model could apply.

5.4. Government as Hiring Agent model

The selection of the credit rating agency could be undertaken by an independent agency, as provided for in the Dodd-Frank Act in the USA.[78] For instance, an independent "Credit Rating Agencies Board" composed of supervisors, representatives of issuers, subscribers/investors and credit rating agencies could be empowered to select a credit rating agency either at random or on the basis of objectively defined criteria to rate an issuer’s structured finance instruments. The issuer would remain free to (1) secure no rating from selected agency at all, or (2) hire additional credit rating agencies if it wished. This measure could effectively prevent "rating shopping" as the rated entity would be rated by the credit rating agency assigned by the independent board (and not exclusively by the one chosen by the issuer on the basis of its likely rating).

5.5. Public Utility model

This alternative would imply a government-created and managed rating agency.[79] This “Public Utility Model” could be designed to check the credit ratings issued by the private credit rating agencies. It could not have the exclusivity to rate, but investors could compare ratings issued by private credit rating agencies with the public/governmental ratings.

<u>Questions 34-36:</u>

(34) Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?

(35) What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the “issuer-pays” model? If so please indicate which alternatives appear to be the most feasible ones and why.

(36) Are there any other alternatives to be considered? If so please explain.

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The policy orientations put forward in the five sections above relate to specific issues identified to strengthen the regulatory framework for credit rating agencies; however it is possible that other issues deserve also the attention of the legislator.

<u>Question:</u>

(37) Are there any other issues that you consider should be tackled in the forthcoming review of the CRA Regulation?

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78 Dodd-Frank Wall Street Reform and Consumer Protection Act of the House of Representatives of 29 June 2010 on the study and rulemaking on assigned credit ratings, Sec. 939F(b)(2), page 523.

79 For instance, an independent Credit Rating Agency, see Section 3.

ANNEX 1 – REFERENCES TO RATINGS IN EU FINANCIAL REGULATION

1) Banking

The Capital Requirements Directive (CRD)[80] requires credit institutions to have their own sound credit granting criteria and credit decision processes in place.[81] This applies irrespective of whether institutions grant loans to customers or whether they incur securitisation exposures. Basing credit decisions solely on external credit rating agency ratings does not fulfil this requirement under EU-banking legislation.

For the specific purposes of calculating regulatory bank capital requirements, rating agency assessments are, in certain instances, applied as a basis for differentiating capital requirements according to risks[82], and not for determining the minimum required quantum of capital itself. The CRD framework as a whole provides banks with an incentive to use internal rather than external credit ratings even for purposes of calculating regulatory capital requirements.[83] In the specific case of securitisation exposures and due to a lack of sufficiently objective internal methodologies within banks, most of them would be expected to calculate their regulatory capital requirements by reference to external ratings.[84]

2) Insurance and reinsurance

The existing directives on the supervision of insurance and reinsurance undertakings do not contain any provisions which place reliance on credit rating agencies. There is actually no credit risk charge for the solvency margin in the existing framework of insurance and reinsurance directives ("Solvency I").[85] However, "Solvency I" is a minimum harmonisation and a number of Member States' national laws implementing the investment and capital requirement rules of the current "Solvency I" Directives[86] do refer to ratings.[87]

The "Solvency II" Framework Directive[88], which introduces risk-oriented solvency requirements for insurance and reinsurance undertakings, addresses credit risk but it does not contain any provisions referring to or placing reliance on credit rating agencies. Capital requirements are calculated using a standard formula or, subject to supervisory approval, by the undertaking's internal model.[89] The precise design of the standard formula capital

[80] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177/1, 30.6.2006).

[81] Annex V point 3 of Directive 2006/48/EC.

[82] This concerns the "Standardized Approach" (Art. 78 ff Directive 2006/48/EC) and Securitizations (Art. 94, 96 Directive 2006/48/EC).

[83] Articles 78 and 84 in connection with Annex VII of Directive 2006/48/EC.

[84] Articles 94, 96 Directive 2006/48/EC.

[85] See provisions on the solvency margin: Articles 27 to 31 of Directive 2002/83/EC, Article 1 of Directive 2002/13/EC of 5 March 2002, OJ L 77, 20.3.2002, and Articles 37 to 39 of Directive 2005/68/EC of 16 November 2005, OJ L 232, 9.12.2005.

[86] Articles 22 to 26 of Directive 2002/83/EC and Articles 20 to 23 of Directive 92/49/EEC.

[87] For example, in the Netherlands, De Nederlandsche Bank publishes credit spreads that (smaller) pension funds can use when they cannot obtain market data to determine buffers to cover against reinsurance defaults. In the United Kingdom, the Insurance Prudential Sourcebook 1.6 provides a table with "listed rating agencies" Credit ratings from these firms are used in determining assumed spread stresses. Ratings are also used in the German insurance sector for asset identification as one possible criterion to determine the safety of the asset.

[88] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) , OJ L 335, 17.12.2009.

[89] Articles 100 to 127 of Directive 2009/138/EC.

requirements, including the market risk and counterparty default risk capital charge, will be set out in the future level 2 implementing measures which are currently being developed. In the fifth Quantitative Impact Study (QIS5)[90], which is currently being carried out, credit ratings are used in the calculation of the standard formula, but QIS5 technical specifications do not prejudge any final decision as regards the standard formula.

3) Pensions

The Institutions for occupational retirement provision (IORP) Directive[91] does not contain any provisions referring or placing reliance on credit rating agencies. A few Members States' rules and supervisory practices regarding IORPs do make use of credit ratings, for example with respect to investment rules and determination of an appropriate discount rate.

4) Investment funds (UCITS)

There is no reference to credit ratings in the UCITS directive.[92] It does not provide for an obligation to take into account external credit ratings in the investment decision making process.

According to Article 6(1) 3. of directive 2007/16/EC[93], an investment grade rating is one of the non-cumulative criteria used for the purpose of the definition of an "establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law as referred to in Article 50(1)(h) of the UCITS directive (definition of issuers of money market instruments eligible for UCITS).

Article 10 (1) a of directive 2007/16/EC clarifies the definition of an embedded derivative. It is modelled on the definition of an embedded derivative incorporated in International Accounting Standard No. 39.[94] The reference to credit rating is an example of a component which can modify the cash flows required by a transferable security. Credit rating can be an underlying of a derivative component of a transferable security (as other variable referred to in this Directive such as interest rates and financial instruments prices.). It means that a certain credit rating can trigger a payment obligation. Accordingly, subsequent up or downgrades of the credit rating may have an impact on the cash flows.

5) Money market funds

There are no references to external ratings in the UCITS directive with respect to money market funds. However, the CESR Guidelines on money market funds[95] contains references to external ratings. According to this guideline, when assessing the quality of a money

[90] In order to assess its impact the development of "Solvency II" is accompanied by five Quantitative Impact Studies. In these studies insurance and reinsurance undertakings as well as insurance groups under the scope of "Solvency II" determine their eligible own funds and capital requirements according to preliminary specifications of the new rules.

[91] Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235/10, 23.9.2003.

[92] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302/32, 17.11.2009.

[93] Directive 2007/16/EC of the European Parliament and of the Council of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions, OJ L 79/11 of 20.3.2007.

[94] The objective of this IAS 39 is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

[95] CESR's guidelines on a common definition of European money market funds of 19 May 2010, CESR/10-049. These guidelines are not legally binding but national regulators will be expected to implement them.

market instrument, a management company must consider the credit quality of that instrument. For this purpose a money market instrument is not considered to be of high quality unless it has been awarded one of the two highest available short-term credit ratings by each recognised CRA that has rated the instrument or, if the instrument is not rated, it is of equivalent quality as determined by the management company's internal rating process. However, the guideline clarifies that the responsibility for the assessment of the quality of a money market instrument lies with the management company. In making such assessment it should take into account a range of factors and should not place undue weight on the credit rating of the instrument. Money market funds may hold sovereign issuances of at least investment grade as awarded by one or more recognised CRAs.

6) Investment firms

For the purposes of defining high quality money market instruments that must be held by qualifying money market funds (which are allowed – at par with credit institutions and other eligible entities – to receive on a temporary basis clients funds from an investment firm), Article 18 of Directive 2006/73/EC (the MiFID Implementing Directive)[96] makes reference to ratings of these instruments issued by competent CRAs.[97] It requires that these instruments should have been awarded the highest available credit rating by each competent rating agency which has rated that instrument. An instrument that is not rated by any competent rating agency shall not be considered to be of high quality.

7) Disclosure requirements for securities

When securities are offered to the public or admitted to trading on a regulated market according to the Prospectus Directive[98] a prospectus needs to be published. On debt issues for instance Annex V paragraph 7.5 of the Prospectus Implementing Regulation[99] requires that the prospectus must contain information on credit ratings – if available – assigned to an issuer or its debt securities at the request or with the cooperation of the issuer in the rating process including a brief explanation of the meaning of the ratings if this has previously been published by the rating agency.

8) ECB Regulation

The Eurosystem credit assessment framework (ECAF) defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met..[100]

In the assessment of the credit standard of eligible assets, the Eurosystem takes into account credit assessment information from credit assessment systems belonging to one of four sources, namely:

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96 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006).

97 According to the same article, a rating agency shall be considered to be competent if it issues credit ratings in respect of money market funds regularly and on a professional basis and is an eligible external credit assessment institution (ECAI) within the meaning of Article 81(1) of Directive 2006/48/EC.

98 Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345/64, 31.3.2003).

99 Regulation (EC) No 809/2004 implementing Directive 2003/71/EC (OJ L 215/3, 16.6.2004).

100 The general documentation on the ECAF is in Section 6.3 of the General Documentation, Section 6.3, as well as the amendments set out in Guideline ECB/2009/01, available from http://www.ecb.int/paym/coll/elisss/html/index.en.html.

- external credit assessment institutions (ECAIs),
- NCBs' in-house credit assessment systems (ICASs),
- counterparties' internal ratings-based (IRB) systems, or
- third-party providers' rating tools (RTs).

Additionally, in the assessment of the credit standard the Eurosystem takes into account institutional criteria and features guaranteeing similar protection for the instrument holder such as guarantees.

The Eurosystem's normal benchmark for establishing its minimum requirements for credit quality threshold is defined in terms of a "single A" credit assessment—corresponding to a probably of default (PD) over a one-year horizon of up to 0.10 percent. In October 2008, the credit quality threshold was temporarily relaxed and allowed to admit up to triple-B collateral—with a PD equal to 0.40 percent. In April 2010 the Governing Council of the ECB decided to prolong the use of that category of assets beyond the end of 2010. The new eligible instruments need to be monitored against the credit quality thresholds.

9) State Aid

Credit ratings are currently used by the Commission in assessing measures adopted by Member States under the State aid Rules.

The Communication from the Commission on the revision of the method for setting the reference and discount rates and the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees[101] uses an entity's credit rating to establish whether state guarantees or loans constitute State aid.[102]

In assessing whether state guarantees are being appropriately priced pursuant to the Communication from the Commission on the Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis[103], the Commission will use a bank's credit rating as a measure of its creditworthiness.

In addition, the current rating and the outlook of a financial institution is one of the four criteria set out in Annex I of the Commission Communication on Recapitalisation of Financial Institutions of 5 December 2008[104] for evaluating whether a bank can be classified as sound or distressed. However, this Communication is currently being revised and as such, this requirement may be removed from the rules applicable from January 2011 onwards.

Further, the Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector of 25 February 2009[105] requires banks to disclose the current rating for each basket of activities they hold, such as structured products and securitised positions. This information is key to the assessment of the impaired assets which are to be transferred to or guaranteed by a Member State.

[101] OJ C 155, 20.6.2008, p. 10–22.
[102] OJ C 14, 19.1.2008, p. 6–9.
[103] OJ C 270, 25.10.2008, p.8.
[104] OJ C 10, 15.1.2009, p. 2-10.
[105] OJ C 72, 26.03.2009, pages 1-22.