

Important note:

This document is a working document of the Commission services for consultation.

It does not purport to represent or pre-judge the formal proposals of the Commission.

You are invited to comment on the proposals in this paper. The proposals are only an indication of the approach the European Commission may take and are not its final policy position.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our proposals to refine and develop our policies on the use of credit ratings in the regulatory context. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account when we prepare our final policy position.

DG MARKET SERVICES DOCUMENT

Tackling the problem of excessive reliance on ratings

I. Subprime lessons on the use of ratings

The excessive reliance of investors on credit ratings is consistently pointed out as one of the triggers of the recent troubles in credit markets. In its report of April 2008¹, the Financial Stability Forum noted that *some institutional investors have relied too heavily on ratings in their investment guidelines and choices, in some cases fully substituting ratings for independent risk assessment and due diligence. Some also relied exclusively on ratings for valuation purposes.* Similar observations were also included in the recent reports of the Committee of European Securities Regulators and the European Securities Markets Expert group².

Consequently, arguments have been raised that greater demand and reliance on ratings by investors has come as a result of the increasing number of references to credit ratings in regulatory requirements. Based on that premise, policy recommendations have been formulated³ that it is necessary to reconsider the existing ties between ratings and regulatory duties on the financial industry: investors should not be obliged or even encouraged to refer to ratings as the sole or ultimate benchmark for assessing asset quality, because it discourages their own consideration and due assessment of the risks involved.

Credit rating agencies (CRAs) provide a service that when done well represents a clear value to the markets: they help address the information asymmetry existing between those issuing debt instruments and those investing in these instruments. Whatever policy is eventually pursued with respect to the problem of excessive reliance, CRA ratings are likely to remain a significant reference point for in-house due diligence performed by investors on the financial assets they hold.

This document identifies in broad terms the references made to ratings in the existing EU legislation and looks at possible approaches to the problem of possible excessive reliance on ratings.

Comments of all interested parties are invited on the identified options.

Deadline for comments: 5th September 2008

Contact point: Markt-G3@ec.europa.eu

¹ *Enhancing Market and Institutional Resilience*, Financial Stability Forum, April 2008, p.37-38.

² Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277); ESME's Report to the European Commission on the Role of Credit Rating Agencies, 4 June 2008.

³ FSF in its report recommends: *Authorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.*, *Enhancing...*, Financial Stability Forum, April 2008, p.37-38.

II. References to ratings in the EU financial *acquis* and in industry practices

1) *Banking*

The Capital Requirements Directive (CRD)⁴ requires banks to have their own sound credit granting criteria and credit decision processes in place. This applies irrespective of whether banks 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 (or the G-10 'Basel 2' requirements for Bank Regulatory Capital).

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, and not for determining the minimum required quantum of capital itself. The CRD framework as a whole provides banks with deliberate and clear incentives to use *internal* rather than external credit ratings even for purposes of calculating regulatory capital requirements. 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.

2) *Central banking*

Several central banks take securities as collateral against their lending as part of their Open Market Operations, in the standing lending facility and for intra-day liquidity in their Real Time Gross Settlement systems. The definition of eligible securities includes the requirement that they are issued by an issuer with a satisfactory credit rating(s) from two or more of the leading rating agencies.

3) *Insurance*

The existing Insurance and Reinsurance Directives 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 Solvency I framework. However, a number of Member States' national laws implementing the investment rules of the current Solvency I Directives do refer to, or place reliance on, ratings in order to decide whether a certain asset is authorised or eligible to cover technical provisions. Moreover, in a number of Member States (re)insurance undertakings are required, as part of their internal reinsurance policy, to pay special attention to the financial strength of their reinsurers using ratings as a proxy.

The Solvency II Framework Directive proposal⁵, which introduces risk-oriented solvency requirements, addresses credit risk but it does not contain any provisions referring to or placing reliance on credit rating agencies. The precise design of capital requirements, including the counterparty default risk capital charge, will be set out in the future level 2 implementing measures to be developed by end 2010. In the 4th Quantitative Impact Study (QIS4) credit ratings have been tentatively used as a proxy for financial strength, but this does not prejudice any final decision as regards the detailed design of capital requirements, which clearly remains an area for further work and consideration.

4) *Pensions*

The Institutions for occupational retirement provision (IORP) Directive⁶ does not contain any provisions referring or placing reliance on credit rating agencies. A few Members States'

⁴ 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) (Official Journal L 177, 30.6.2006, p. 1–200).

⁵ Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (SOLVENCY II) (recast), COM(2008) 119.

⁶ 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

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.

5) *Investment funds*

The UCITS Directive (85/611/EEC⁷ as amended by Directives 2001/107/EC and 2001/108/EC) does not contain provisions which make reference to credit ratings. However, Commission Directive (2007/16/EC)⁸ which clarifies certain definitions used in the UCITS Directive contains 2 references:

1) Article 6 clarifies criteria which can be used to assess the eligibility of non-listed money market instruments which are issued by an "establishment which is subject to, and complies with, prudential rules considered by competent authorities to be as stringent as those laid down by Community law. This provision identifies 4 non-cumulative criteria for concluding that the relevant money market instruments would be eligible for acquisition by a UCITS fund. The third criterion identified is that the issuer of the instrument in question has 'at least investment grade rating.'

2) Article 10 refers to credit ratings in the context of determining whether transferable securities or money market instruments embed a derivative component. This provision is modelled on the definition of an embedded derivative incorporated in International Accounting Standard No. 39. One of several non-cumulative criteria to be used in assessing whether the host security (or money market instrument) embeds a derivative is whether performance of the security (MMI) is sensitive to changes in credit rating of the underlying index or asset.

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 the MiFID Implementing Directive⁹ makes reference to ratings of these instruments issued by competent CRAs¹⁰. 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) *Private contracts*

Credit ratings are very often referred to in private contracts (e.g. loan contracts, where they are used as a trigger to mandatory debt repayment in case the borrower's creditworthiness deteriorates below a stipulated level) or other arrangements between private parties (e.g. investment mandates to be respected by fund managers, which define the minimum quality of expected investments or collaterals using ratings as a benchmark).

⁷ Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) OJ L 375, 31.12.1985, p. 3–18.

⁸ Commission Directive 2007/16/EC 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 (Official Journal L 79, 20.3.2007, p. 11–19, Official Journal L 56 M, 29.2.2008, p. 134–142).

⁹ 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 (Official Journal L 241, 02/09/2006 P. 0026 - 0058)

¹⁰ 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.

III. What could be the way forward?

Commission services wish to consult on three proposals, which are not necessarily mutually exclusive:

1) Require regulated and sophisticated investors to rely more on own risk analysis, especially for (relatively) large investments.

The upcoming COM proposal on CRAs will create the necessary conditions for investors to carry out their own risk assessments. In that regard, CRAs would be required to make public information about their methodologies and models.

In the banking field, the CRD places particular importance on external credit ratings in the context of *securitisation exposures* as outlined above. Therefore, the Commission is already developing concrete measures to make sure that banks look 'beyond' the ratings. If banks fail to do so, they would not be allowed to use the external ratings for regulatory capital calculations and would have to deduct the full securitisation exposure from regulatory capital. Such requirements can be implemented as a comitology measure early next year.

2) Require that all published ratings include 'health-warnings' informing of the specific risks associated with investments in these assets.

3) Examine the regulatory references to CRA ratings and revisit them as necessary.

This examination would cover the different areas where regulatory references to ratings have been identified in EU financial regulation. As a result, changes would be proposed where these references effectively trigger undue reliance of investors on the ratings (or have the potential to do so). At this point, DG MARKT services are of the view that a one-size-fits-all approach need not necessarily be followed, as ratings are used in different contexts, with varying intensity and for different purposes.

Inasmuch as specific regulatory references to ratings exist at national level, DG MARKT services would also encourage the Member States concerned to take the opportunity of reconsidering their usefulness, in an effort to eliminate instances of unnecessary reliance on the opinions of CRAs.