



EUROPEAN COMMISSION
Internal Market DG

Brussels,

**CALL TO CESR FOR TECHNICAL ADVICE ON POSSIBLE MEASURES CONCERNING
CREDIT RATING AGENCIES**

This call for technical advice to CESR follows the Commission commitments at the Oviedo Informal ECOFIN in April 2002, and in the European Parliament in February 2004, to examine the role of credit rating agencies.

In the European Parliament, the Commission identified four issues related to agencies. The Commission is now asking CESR to examine those four issues to the extent that they relate to its field of competence. Some of these issues have already been raised in the context of the Market Abuse Directive. As other issues may be linked to the Commission's Draft proposal on the review of capital requirements for banks and investment firms (CAD III), the Commission recommends that CESR works in collaboration with CEBS. The issues identified by the Commission are not exhaustive and CESR may wish to consider other relevant issues. CESR's examination of the issues and its subsequent advice should be based on an objective assessment of the situation, including any possible market failures and developments in the financial markets.

This call for technical advice to CESR will be made available on DG Internal Market's website.

Without prejudice to the Commission's right of initiative, the European Parliament called on the Commission to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals to deal with this subject.

The requested deadline for delivery of CESR's technical advice is 1 April 2005.

1. BACKGROUND

The decision of the European Commission to provide CESR with a call for technical advice on credit rating agencies, for possible measures, was submitted to the European Securities Committee (ESC) on 5 July 2004. It follows the commitment made by the European Commission at the Informal ECOFIN in Oviedo in April 2002, after the collapse of Enron.

The Commission held an initial discussion on credit rating agencies in the ESC in May 2003. Delegations invited the Commission to take into account the work done by CESR on the Market Abuse Directive on financial research, in addition to the future Community rules for implementing Basle II.

A second discussion followed in September 2003, in the context of the draft Market Abuse Directive implementing measures, during which many ESC delegations requested that the Commission examine actively the issue of credit rating agencies in a broader context.

In February 2004, the European Parliament passed a resolution on the basis of MEP Katiforis' report on the role and methods of credit rating agencies. This report calls on the European Commission to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals to deal with this topic.

Finally, in March 2004, following the Parmalat scandal and the European Parliament resolution adopted by an overwhelming majority, the Commission presented to the ESC the four core issues which it considers need to be addressed in relation to credit rating agencies, and which the Commission had also identified in the European Parliament debate in February:

- (i) potential conflicts of interests within rating agencies;
- (ii) transparency of rating agencies' methodologies;
- (iii) legal treatment of rating agencies' access to inside information; and
- (iv) concerns about possible lack of competition in the market for provision of credit ratings.

The technical advice delivered by CESR on the Market Abuse Directive might constitute a starting point on some aspects of the call for advice. However, as the role of credit ratings is being reinforced by developments in the Basle II banking legislation, the Commission recommends that CESR works in collaboration with CEBS.

The aim of the call is for CESR to provide the Commission with technical analysis and advice relating to the identified questions¹ in order for the Commission to assess the need, or not, for introducing European legislation or other solutions in this field.

¹ Without prejudice to the competences of DG Competition of the European Commission on competition issues. For information, let us recall that on 12 March 2003, Commissioner Monti delivered the Commission's answer to European Parliament written question E-0044/03 regarding potential competition issues related to auditors and rating agencies.

In view of the commitment made by the Commission at the Oviedo Informal ECOFIN Council, the July 2005 deadline mentioned in European Parliament's resolution and the numerous public contributions already made on the topic, the Commission requests CESR's advice by 1 April 2005.

2. THE WORKING APPROACH AGREED BETWEEN DG INTERNAL MARKET AND THE EUROPEAN SECURITIES COMMITTEE

DG Internal Market of the Commission consulted the European Securities Committee on 5 July on its call for technical advice. At that meeting, it was agreed that CESR should start the work immediately, in collaboration with CEBS.

CESR should act in accordance with its normal consultation practices, consulting with market participants, consumers and end-users (as well as the other bodies specified in the call for advice) before it provides advice to the Commission.

Once the Commission has received CESR's report for technical advice, it will consider whether any European legislation or other solutions are needed.

3. CESR IS INVITED TO PROVIDE ADVICE ON AT LEAST THE FOLLOWING PRIORITY ISSUES BY 1 APRIL 2005

In recognition of the fact that the largest credit agencies, and many companies that they rate, compete in global markets, CESR's work, to be carried out in collaboration with CEBS, should involve close contact with the United States Securities and Exchange Commission (SEC), which is currently working on this subject, in order to maximise the opportunity for the convergence of principles between the European and US regulatory approaches.

Another major dimension is the Basle II agreements. As these agreements will reinforce at international level the deployment of credit ratings into banking legislation, it seems crucial to consider this legal dimension when assessing the topic of credit rating agencies. In particular, due attention should be paid to the forthcoming Commission's Draft proposal on the review of capital requirements for banks and investment firms (CAD III).

A third dimension is discussions held in many public fora, including IOSCO, in recent years. A summary of these various initiatives is annexed to this call for advice.

3.1. TECHNICAL ADVICE RELATED TO THE ISSUE OF INTERESTS AND CONFLICTS OF INTEREST FOR CREDIT RATING AGENCIES

DG Internal Market requests that CESR provide technical advice on the major issues of interests and conflicts of interest for credit rating agencies and its views on the optimal regulatory ways to deal with them.

(1) *Technical advice related to the issue of provision of advisory/ancillary services by credit rating agencies*

The technical advice should at least take into account:

- the risk that the provision of advisory services by rating agencies to issuers they rate might influence the rating of these issuers;
- the possible consequent need to disclose, manage or prohibit such advisory services;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

(2) *Technical advice related to the issue of payment for credit ratings to credit rating agencies by rated issuers*

The technical advice should at least take into account:

- the risk that payments for credit ratings to the rating agencies by subscribing issuers might influence the rating of these issuers;
- the possible consequent need to disclose the existence (but not the amount) of, or manage, such payments;
- the issue of unsolicited ratings turned into solicited;
- the possible consequent need to disclose, or manage, unsolicited ratings;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

(3) *Technical advice related to the issue of capital links or any other interest links between rated issuers and credit rating agencies*

The technical advice should at least take into account:

- the risk that capital links (such as shareholdings or loans) or any other interest links between rated issuers and credit rating agencies might influence the rating of these issuers;
- the possible consequent need to disclose the existence of such links along with the rating;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

3.2. TECHNICAL ADVICE RELATED TO THE FAIR PRESENTATION OF CREDIT RATINGS

DG Internal Market requests CESR to provide technical advice on whether measures are required to deal with the issue of fair presentation of credit ratings, including skills of agencies' staff and rating methodologies.

(1) *Technical advice related to the level of skills of agencies' staff*

The technical advice should at least take into account:

- the risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments;
- the possible consequent need to disclose or regulate such skills, taking into account an analysis of the relative risks of different regulatory and non-regulatory options;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards the fair presentation of investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions contained in the Commission's proposed review of capital requirements for banks and investment firms; the provisions of Article 13 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of this Article. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of organisational aspects, compliance and audit functions foreseen for investment firms.

(2) *Technical advice related to methodologies used for building credit ratings*

The technical advice should at least take into account:

- the risk that inappropriate, undisclosed or weak methodologies might lead to biased credit ratings or to biased interpretation of credit ratings;
- the possible consequent need to disclose or regulate such methodologies, taking into account an analysis of the relative risks of different regulatory and non-regulatory options;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC ('Market Abuse Directive') and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards fair presentation of investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions contained in the Commission's proposed review of capital requirements for banks and investment firms;
- the comparability of ratings within and across Member States for various categories of economic entities, with particular attention to SMEs.

3.3. TECHNICAL ADVICE CONCERNING THE RELATIONSHIP BETWEEN ISSUERS AND

RATING AGENCIES

3.3.1 Technical advice concerning the access to inside information from issuers by rating agencies

DG Internal Market requests that CESR provide technical advice on whether measures are required to deal with the issue of access to inside information from issuers by credit rating agencies.

Technical advice related to the access to inside information by credit rating agencies

The technical advice should at least take into account:

- the existing lack of clarity and harmonisation of legislation relating to access to inside information from issuers by rating agencies;
- the need to investigate appropriate measures to ensure that inside information is not inadvertently disseminated, selectively disclosed or misused in other ways;
- the need to ensure a level playing field between credit rating agencies;
- the provisions of Articles 1, 2, 3 and 6 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/124/EC implementing the Market Abuse Directive as regards the definition and public disclosure of inside information while recognising the differences between credit ratings and investment recommendations.

3.3.2 Technical advice concerning other issues related to the relationship between issuers and rating agencies

DG Internal Market requests that CESR provide technical advice on whether measures are required to deal with other issues related to the relationship between issuers and rating agencies.

Technical advice related to other issues concerning the relationship between issuers and rating agencies

The technical advice should at least take into account:

- the need to ensure that issuers periodically have the opportunity to discuss with rating agencies the assumptions and fundamental determinants of their ratings;
- the need to ensure that information published by rating agencies (alongside rating opinions) is accurate and the role issuers are to play in such a process;
- the need for issuers to understand how rating agencies restate the figures they give them;

- the importance of rating agencies archiving all information related to a rating so that a rating decision can be explained to issuers at a later stage;
- the need for all rating agencies to have access to the same information from companies (rating agency data room).

3.4. TECHNICAL ADVICE RELATED TO POSSIBLE ENTRY BARRIERS TO THE MARKET FOR THE PROVISION OF CREDIT RATINGS

Any assessment of whether there might be a lack of competition, or concentration of market power, in the market for the provision of credit ratings, would fall within the competences of DG Competition of the Commission and does not form part of this call for advice. Nevertheless, DG Internal Market requests that CESR provide technical advice on whether there are entry barriers to this market that could be removed or alleviated.

Technical advice related to availability of credit ratings and to the existence of possible entry barriers to the market for the provision of credit ratings

The technical advice should at least take into account:

- whether there are any entry barriers to the market for credit ratings arising from regulatory requirements or otherwise and, if so, whether measures could/should be taken to reduce or remove any such barriers;
- the new framework for capital requirements for banks and investment firms;
- the coverage and availability of credit ratings in different Member States for various categories of economic entities, with particular attention to SMEs.

3.5. TECHNICAL ADVICE RELATED TO THE USE OF RATINGS IN EUROPEAN LEGISLATION AND IN PRIVATE CONTRACTS

European legislation makes use of ratings as a regulatory instrument. The proposed framework for capital requirements for banks and investment firms would extend the use of ratings in European legislation. From a technical point of view, does CESR consider that further use of ratings in European legislation should be encouraged beyond these measures?

Are there issues relating to the use of ratings in private contracts?

3.6. REGISTRATION

Taking account of 3.1-3.5 and on the basis of analysis of financial markets – including any possible market failures – does CESR consider it appropriate that credit rating agencies should be registered in the EU? If so, how and under what type of regime, bearing in mind the need to avoid giving investors the impression of an absolute guarantee of quality of ratings?