



EUROPEAN COMMISSION

Brussels, 15.11.2011
COM(2011) 746 final

2011/0360 (COD)

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings

(Text with EEA relevance)

{SEC(2011) 1354}

{SEC(2011) 1355}

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

Regulation (EC) No 1060/2009 on credit rating agencies¹ (CRA Regulation) entered into full application on 7 December 2010. It requires credit rating agencies (CRAs) to comply with rigorous rules of conduct in order to mitigate possible conflicts of interest, ensure high quality and sufficient transparency of ratings and the rating process. Existing CRAs had to apply for registration and to comply with the requirements of the Regulation by 7 September 2010.

On 11 May 2011 an amendment to the CRA Regulation² (Regulation (EU) No 513/2011) was adopted, entrusting the European Securities and Markets Authority (ESMA) with exclusive supervisory powers over CRAs registered in the EU in order to centralise and simplify their registration and supervision at European level.

However, a number of issues related to credit rating activities and the use of ratings have not been sufficiently addressed in the existing CRA Regulation. One of these issues is the risk of overreliance on credit ratings by financial market participants, including undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIFs)³.

The European Commission pointed to these open issues in its Communication of 2 June 2010 ("Regulating financial services for sustainable growth")⁴ and in a consultation paper of the Commission services of 5 November 2011⁵ announcing the need for a targeted review of the CRA Regulation which is delivered with this proposal.

On 8 June 2011, the European Parliament issued a non-legislative report on CRAs⁶. The report supports, inter alia, the need to enhance the regulatory framework for credit rating agencies and to take measures to reduce the risk of over-reliance of ratings.

At an informal ECOFIN meeting of 30 October 2010 the Council of the European Union acknowledged that further efforts should be made to address a number of issues related to credit rating activities, including the risk of over-reliance on credit ratings and the risk of conflict of interests stemming from the remuneration model of rating agencies. The European Council of 23 October 2011 concluded that progress is needed on reducing overreliance on credit ratings.

¹ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJ L 302, 17.11.2009.

² Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011.

³ Overreliance on external credit ratings occurs when financial institutions and institutional investors rely solely or mechanistically on ratings issued by credit rating agencies while neglecting their own due diligence and internal risk management obligations. Overreliance on credit ratings may lead to herding behaviour of financial actors, e.g. parallel selling-off of debt instruments after that instrument has been downgraded below investment grade, which may affect financial stability – in particular when the few big rating agencies err collectively in their assessments.

⁴ COM(2010)301 final.

⁵ Available at http://ec.europa.eu/internal_market/consultations/2010/cra_en.htm.

⁶ <http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=en&procnum=INI/2010/2302>.

At the international level, the Financial Stability Board (FSB) issued in October 2010 principles to reduce authorities' and financial institutions' reliance on external ratings⁷. The principles call for removing or replacing references to such ratings in legislation where suitable alternative standards of creditworthiness are available and for requiring investors to make their own credit assessments. Those principles were endorsed by the G 20 Seoul Summit in November 2010.

2. RESULTS OF CONSULTATIONS WITH THE INTERESTED PARTIES AND IMPACT ASSESSMENTS

The European Commission conducted a public consultation from 5 November 2010 to 7 January 2011 presenting various options to address the issues identified, including the question of over-reliance. The Commission received approximately 100 contributions from stakeholders which have been taken into account in drafting this proposal. A summary of the responses to the consultation paper can be found at

http://ec.europa.eu/internal_market/securities/docs/agencies/summary-responses-cra-consultation-20110704_en.pdf.

On 6 July, the Commission services held a roundtable in order to obtain further feedback from relevant stakeholders on these issues. A summary of the roundtable can be found at

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

An impact assessment has been produced for this proposal. It can be found at

http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

3. LEGAL ELEMENTS OF THE PROPOSAL

3.1. Legal basis

It is necessary, in order to reduce the risk of over-reliance of managers of UCITS and AIFs on credit ratings, to introduce amendments to Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of law, regulations and administrative provisions relating to the undertakings for collective investment in transferable securities (UCITS)⁸ and Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers⁹. The Commission is presenting in parallel a proposal of Regulation for the amendment of the CRA Regulation, based on Article 114 of the Treaty of the Functioning of the European Union (TFUE).

However, that proposal of Regulation would not be the appropriate legal instrument for the amendment of these directives. On the one hand, those amendments include provisions which are not directly applicable and need transposition into national law. On the other hand, the proposal for the amendments of Directive 2009/65/EC and Directive 2011/61/EU should rather be based on Article 53(1) of the TFUE, which provided the legal basis for the latter

⁷ http://www.financialstabilityboard.org/publications/r_101027.pdf

⁸ OJ L 302, 17.11.2009, p.32.

⁹ OJ L 174, 1.7.2011, p.1.

Directive. Directive 2009/65/EC was based on the corresponding Article 95 of the Treaty establishing the European Community.

Therefore, it appears appropriate that the draft amendments to Directive 2009/65/EC and 2011/61/EU are presented in a proposal for a Directive based on Article 53(1) TFUE.

3.2. Subsidiarity and proportionality.

According to the principle of subsidiarity (Article 5(3) of the TUE), action at the EU level should be taken only where the aims envisaged cannot be achieved sufficiently by Member States alone and can therefore, by reason of the scale and effects of the proposed action be better achieved by the EU. The business of credit rating agencies is global and has been regulated at EU level. Ratings used by a credit rating agency based in one Member State are used and relied upon by market participants throughout the EU. Similarly, EU legislation has provided for a prudential regulatory framework for investment funds, whether UCITS or AIFs, which allows authorised funds to operate throughout the EU. Failures or a lack of regulatory framework in one specific Member State could adversely affect market participants and financial markets EU-wide. Therefore, sound regulatory rules applicable throughout the EU are necessary to protect investors and markets from possible shortcomings. Therefore, any further action to reduce the over-reliance on credit ratings by UCITS and AIFs can best be achieved by EU action.

The proposed amendments are also proportionate, as required by Article 5(4) TUE. The amendments do not exceed what is necessary to achieve their objectives. The provisions on the reduction of the reliance on credit ratings are integrated into the general obligation for management and investment companies (as regards UCITS) and AIFMs (as regards AIFs) to employ risk-management processes or systems. The provisions proposed are very similar to the ones recently proposed by the Commission as regards credit institutions¹⁰.

This proposal supplements the Commission proposal, submitted in parallel, for a Regulation amending the CRA Regulation, which contains other provisions regarding, *inter alia*, the reduction of the excessive reliance by market participants on credit ratings. Further to setting this general principle on the avoidance of over-reliance, the proposal for the amendment of the CRA Regulation provides for some measures that should facilitate investors' achievement of that objective. Hence, it foresees that investors should be able to have access to additional information disclosed to the market by credit rating agencies and issuers of structured finance instruments. Credit rating agencies should disclose information on their rating methodologies and underlying assumptions, on any proposed changes to their methodologies or on specific information on certain types of credit ratings, such as sovereign ratings. Issued credit ratings should also become easily comparable for investors thanks to the European Rating Index (EURIX) to be operated by ESMA and incorporating harmonised rating scales. Issuers of structured finance instruments should provide more information on their products to the market, including information on the credit quality and performance of the individual underlying assets of the structured finance instrument, the structure of the securitization transaction, the cash flows or any collateral supporting a securitisation exposure. This

¹⁰ Commission proposal of 20 July 2011 for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM(2011) 453 final. See point (b) of Article 77.

additional information should facilitate that investors, such as UCITS or AIFs, could make their own credit risk assessments and need not systematically and mechanically rely on credit rating agencies to assess the creditworthiness of the instruments, in particular structured finance instruments, in which they invest.

3.3. Explanation of the proposal

3.3.1. Amendment of Directive 2009/65/EC on UCITS

Directive 2009/65/EC provides for the regulation at the EU level of UCITS. UCITS meeting certain conditions are therefore allowed to operate across the Union. Article 51 of this Directive established some prudential requirements as regards risk management. It requests in particular that a management or investment company managing UCITS should employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio. The Commission received delegated powers to specify, through delegated acts, the criteria for assessing the adequacy of the risk management process employed by those managing the UCITS.

Article 1 of the proposal amends Article 51 of Directive 2009/65/EC as regards the risk management process:

- point (1) introduces a requirement for the management or investment company not to solely or mechanistically rely on external credit ratings for assessing the creditworthiness of the UCITS assets. External credit ratings may be used as one factor among others in this process but shall not prevail;
- point (2) proposes corresponding amendments to the existing empowerments for the Commission to adopt delegated acts with a view to specifying the provisions of Article 51(1) of 2009/65/EC.

3.3.2. Amendment of Directive 2011/61/EC on managers of AIFs

Similarly, Directive 2011/61/EU provides for the regulation at the EU level of managers of alternative investment funds (AIFs). AIFs meeting certain conditions are therefore allowed to operate across the Union. Article 15 of Directive 2011/61/EU established some prudential requirements as regards risk management. It requests in particular that the manager of an AIF should implement adequate risk-management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed. The Commission received delegated powers to specify, through delegated acts, the risks management systems to be employed by the managers of AIFs in relation to the risks they incur on behalf of the AIFs they manage.

Article 2 of the proposal amends Article 15 of Directive 2011/61/EU as regards the risk management systems:

- point (1) introduce a requirement for the AIF Manager not to solely or mechanistically rely on external credit ratings for assessing the creditworthiness of the AIF assets. External credit ratings may be used as one factor among others in this process but shall not prevail;

- point (2) proposes corresponding amendments to the existing empowerments for the Commission to adopt delegated acts with a view to specifying the provisions of Article 15(1) of Directive 2011/61/EU.

3.3.3. *Transposition*

The proposal provides for a transposition period of 12 months.

4. BUDGETARY IMPLICATION

The Commission's proposal has no impact on the European Union budget.

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 53(1) thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national Parliaments,

Having regard to the opinion of the European Central Bank¹,

Having regard to the opinion of the European Economic and Social Committee²,

Acting in accordance with the ordinary legislative procedure,

Whereas:

- (1) Directive 2009/65/EC of the European Parliament and of the Council³ provides for regulation at Union level of undertakings of collective investment in transferable securities (UCITS). Similarly, Directive 2011/61/EU of the European Parliament and of the Council⁴ provides for regulation at the Union level of managers of alternative investment funds (AIFs). Both directives establish prudential requirements as regards risk management by management or investment companies managing UCITS or managers of AIFs, respectively.
- (2) An effect of the financial crisis has been that investors, including UCITS and AIFs, rely excessively on credit ratings to carry out their investments on debt instruments, without necessarily conducting their own assessments of the creditworthiness of issuers of such debt instruments. In order to improve the quality of the investments

¹ OJ C , , p. .

² OJ C , , p. .

³ OJ L 302, 17.11.2009, p.32.

⁴ OJ L 174, 1.7.2011, p.1.

made by UCITS and AIFs and, therefore, to protect investors in those funds, it is appropriate to require the persons managing UCITS and AIFs to avoid relying exclusively and automatically on external credit ratings when assessing the risk involved in the investments made by the UCITS and AIFs they manage. The general principle on the avoidance of excessive reliance on external credit ratings should therefore be integrated into the risk management processes and systems of the managers of UCITS and AIFs, and adapted to their specificities.

- (3) In order to specify further the general principle on overreliance that should be introduced into Directives 2009/65/EC and 2011/61/EU, the power to adopt acts in accordance with Article 290 of the Treaty on the Functioning of the European Union should be delegated to the Commission in particular to ensure that managers of UCITS and AIFs are effectively prevented from over-relying on external credit ratings for assessing the creditworthiness of the assets held by UCITS or AIFs. It is appropriate in this regard to amend the powers of the Commission in those Directives to adopt delegated acts in respect of the general provisions regarding risk management processes and systems employed by the managers of UCITS and AIFs. It is of particular importance that the Commission carry out appropriate consultations during its preparatory work, including at expert level.
- (4) The relevant measures should be complementary to other provisions in Regulation (EU) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies⁵ as amended by Regulation (EU) No [xxx/xxxx] of the European Parliament and of the Council of [xxx xxx xxxx] amending Regulation (EU) No 1060/2009⁶. Those provisions set the general objective of reducing excessive reliance by investors on external credit ratings and should facilitate the achievement of that aim.
- (5) Since the objective of this Directive, namely to contribute to the reduction of the excessive reliance of UCITS and AIFs on external credit ratings when making their investments, cannot be sufficiently achieved at the Member State level and can therefore, by reason of the pan-Union structure and impact of the activities of UCITS, AIFs and credit rating agencies, be better achieved at the Union level, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on the European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve those objectives.
- (6) Directive 2009/65/EC and Directive 2011/61/EU should therefore be amended accordingly,

⁵ OJ L 302, 17.11.2009, p. 1.

⁶ OJ L [...], [...], p. [...].

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Amendments to Directive 2009/65/EC

Article 51 of Directive 2009/65/EC is amended as follows:

- (1) in paragraph 1, the first subparagraph is replaced by the following:

'A management or investment company shall employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio. In particular, it shall not solely or mechanistically rely on external credit ratings for assessing the creditworthiness of the UCITS assets.';

- (2) in paragraph 4, point (a) is replaced by the following:

'(a) criteria for assessing the adequacy of the risk management process employed by the management company in accordance with the first subparagraph of paragraph 1. These criteria shall ensure that the management company is prevented from relying solely or mechanistically on external credit ratings for assessing the creditworthiness of the UCITS assets;'.

Article 2

Amendments to Directive 2011/61/EU

Article 15 of Directive 2011/61/EU is amended as follows:

- (1) in paragraph 2, the first subparagraph is replaced by the following:

'AIFMs shall implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed. In particular, AIFMs shall not solely or mechanistically rely on external credit ratings for assessing the creditworthiness of the AIF assets.';

- (2) in paragraph 5, point (a) is replaced by the following:

'(a) the risks management systems to be employed by AIFMs in relation to the risks which they incur on behalf of the AIFs they manage. These risk management systems shall prevent AIFMs from relying solely or mechanistically on external credit ratings for assessing the creditworthiness of the AIF assets.'.

Article 3

Transposition

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by XX XXXX [12 months from the date of entry into force of the directive] at the latest. They shall forthwith communicate to the Commission the text of those provisions and a correlation table between those provisions and this Directive.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 4

Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 5

Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament
The President

For the Council
The President