

# **Overview of responses to Public Consultation on Credit Rating Agencies**

## **1. OVERRELIANCE ON EXTERNAL CREDIT RATINGS**

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

Many responses echoed concerns about overreliance on ratings, and although there is support for reducing references to ratings in legislation gradually, so as to avoid a shock, even from some CRAs as well as some regulators. Respondents including regulators noted that part of the challenge will lie in finding suitable measures to replace them. Using market measures instead of ratings was seen as inappropriately pro-cyclical and volatile by many including industry groups and governments, but at the same time they could be taken into account alongside other measures and or good quality ratings according to national regulators, governments, banks and industry groups. Respondents including banks also felt that good quality ratings were helpful and should continue to be used, but that it was important to incentivise the development of internal ratings abilities for firms with sufficient resources. There was concern from respondents such as investor groups and governments about firms investing in instruments whose credit risk was difficult to assess independently, although several respondents, especially industry representatives felt that this was sufficiently addressed in CRD II. However respondents noted that risk is necessary in the financial markets and that external ratings could continue to be used alongside internal ratings models so long as they were of reliable quality. There was opposition to the idea of requiring multiple ratings from most sectors of respondents, including banks, governments, industry associations.

Many responses drew the attention to ongoing work in Basel (in particular on the capital framework for securitisations) and suggested waiting for the outcome of this work.

### **1.2 Use of external ratings for internal risk management purposes**

There was widespread support for a requirement for firms to conduct their own due diligence without relying exclusively on ratings from respondents in several categories, including industry associations, governments and regulators and rating agencies. However, there was a small amount of concern regarding smaller firms' abilities to perform such analysis. It was mentioned that current sectoral legislation already contains such requirements which have recently been strengthened. A range of different stakeholders, among them governments, industry associations and regulators, offered support for increased transparency including disclosure of firms' reliance on external ratings. There was also strong support for all information used by CRAs for rating structured finance instruments to be made available to everyone while some expressed concern about the costs of such a measure, confidentiality issues and international consistency. While there were mixed views on whether or not sovereign debt ratings were based on publically available information – some felt that private meetings were also involved, or that even if based on public information, CRAs added value, not all respondents thought this meant that all firms would have the capacity to analyse this information similarly.

### **1.3 Use of external ratings in the mandates and investment policies of investment managers**

There was considerable support for avoiding mechanistic use of ratings, with some regulators, governments and several industry associations supporting a 'flexibility clause', while other respondents from the same groups did not support such a clause. However, industry associations, several governments and regulators CRAs were mostly cautious regarding the introduction of specific legislation to mandate flexibility and proportions of portfolios dependent on ratings, with support for market-led approaches and for investment managers to rely on their judgment. There was again caution from some governments, CRAs and industry groups against relying on market data to measure credit risk, though few proposals for alternatives to external ratings. On the other hand, some of the same stakeholder groups proposed that cautiously, and for the right assets only, market measures could be used.

## **2. SOVEREIGN DEBT RATINGS**

### **2.1 Enhance transparency and monitoring of sovereign debt ratings**

There was a general consensus that sovereign issuers should not receive fundamentally different treatment to corporate issuers. There were calls from some governments and industry stakeholders for increased transparency regarding methodologies and publication of the full research reports underlying ratings, although a small number in this group opposed this idea. Some governments wished to propose a maximum period of time for the review of sovereign ratings. On the other hand, many respondents, across all stakeholder groups, including some rating agencies, was that sovereigns should not be treated significantly differently from other issuers, albeit a few stating that CRAs should be more alert to changes in all cases. The 3 days' notice measure, while supported by some Member States and regulators, caused to some others Member States and regulators concern, in particular because of risks of market abuse and conflict of interest issues.

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

In terms of ratings methodologies, there was strong support from various kinds of respondents for an improved transparency, and further calls to treat sovereign issuers in a similar way to corporate issuers. There was some support including from some regulators for postponing publication until close of business, but on the other hand, many respondents, including other regulators and Member States' considered this less effective when trading continues around the globe. Fewer respondents approached the issue of Member States not paying for ratings, with no real discernible trends of groups in favour or against: some felt that this would not reduce conflicts of interest, while others supported the measures and asked for a common European approach.

## **3. ENHANCING COMPETITION IN THE CREDIT RATING INDUSTRY**

Overall, there was general concern about the lack of competition in the credit rating industry, but caution against interventions in this commercial market, with importance placed on maintaining a level playing field. On the other hand there were some propositions for increasing competition, such as driving demand by requiring more ratings by a greater

number of agencies, encouraging specialists, but there was similarly some representation against specific legislation in this area.

### **3.1 European Central Bank or National Central Banks**

There was not significant support among stakeholders for the ECB or Member States' National Central Banks to establish ratings. While some governments and regulators were supportive of this idea, others were sceptical of public sector involvement in the ratings sphere.

### **3.2 New National Entrants**

A limited number of stakeholders responded in this area. Some governments, finance industry groups said that if such an option would be pursued, operational independence would be a key factor. On the other hands, some other governments, finance industry groups and CRAs were against state intervention to stimulate new entrants.

### **3.3 Public/Private structures**

Some Member States proposed the idea of Public/private structures to be further considered and analysed. At the same time, some of these respondents further noted the problems of credibility and conflicts of interest that could be caused by direct funding arrangements and which would need to be addressed. Some national regulators and several private enterprises opposed the creation of a new European CRA.

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

There was some support from a group of Small and Medium-sized CRAS for the idea of a European Network of Small and Medium-sized Rating Agencies. However, some regulators, and governments felt this would not be effective.

## **4. CIVIL LIABILITY OF CREDIT RATING AGENCIES**

Several respondents from various stakeholder groups encompassing some governments, regulators and banking industry bodies supported the possibility of civil liability claims against CRAs, but only for gross negligence or intent. Several respondents including respondents from all stakeholder groups expressed concerns about respecting existing legal systems, and the difficulty in establishing and disruption that caused by simply applying a common standard across all of them. Taking responses as a whole to this section, there seemed to be general support (with the notable exception of the CRAs themselves, arguing that this would, for instance, increase reliance) for the notion that it should be possible to pursue civil action, in the case of both solicited and unsolicited ratings, but that this should be reserved for severe cases only, not simply where investors suffer loss. Other measures proposed included increased regulatory scrutiny and punishment of offenders. There was very little support for introducing the concept of an 'incorrect' rating. .

## **5. POTENTIAL CONFLICTS OF INTEREST DUE TO THE “ISSUER-PAYS” MODEL**

Respondents agreed that the “issuer-pays” model inherently contains conflicts of interest, although respondents of all kinds also stated that it should be possible to manage and minimise these conflicts, and in addition, other models were also conflicted.

### **5.1. “Subscriber/Investor-Pays” model**

Some financial firms and their industry bodies felt that increasing the cost of investment risked reducing demand for securities. Further respondents including competent authorities and governments noted that this model could reduce the independence of CRAs.

### **5.2. “Payment-upon-results” model**

Some national authorities, government and trade bodies of financial firms were opposed to this idea and expressed scepticism as to the feasibility of implementing such a system. One trade body and one national authority were concerned that this model could lead to the erroneous notion of "right" or "wrong" ratings.

### **5.3. “Trading venues Pay” model**

There was some support from the academic sphere for this model. However, among market participants, public authorities and interested third parties, this model was not a favoured option, especially in view of the large number of unlisted securities which would not be covered.

### **5.4. Government as Hiring Agent model**

Governments responding to this question felt that this model had negative implications for conflicts of interest. There were also concerns about cost and how the model could be operated.

### **5.5. Public Utility model**

The trade bodies and public authorities responding to this option were concerned at the expense of such an option, and some of these had concerns about increasing overreliance and regarding conflicts of interest, particularly rating of sovereign debt during a crisis.

## **Overall outcome**

Overall, throughout the responses to the consultation, there were occasional calls for the Commission to wait for the full effect of CRA I and CRA II to become known, and some respondents called for the work of the G20 and Basel to be taken into account. Participants recognised the importance of the issues addressed by the Consultation and there was general support for the work of the Commission in this area.