



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS

Director

Brussels, 28.11.07 00004554  
MARKT G3/PP/cr D(2007)

Mr John Holland  
European Securities Markets Expert  
Group  
'Credit Rating Agencies' subgroup  
Rapporteur

E-mail: [john.holland@ubs.com](mailto:john.holland@ubs.com)

Dear John,

Please find herewith a mandate for the European Securities Markets Expert Group to advise the Commission on certain issues concerning the role of credit rating agencies (CRAs) and the importance of ratings in the financial markets, and in particular in the field of structured finance.

The Commission will use the ESME's advice to complete its own assessment of the rating agencies' activities and their role in the recent crisis in the financial markets.

I trust that the valuable contribution of ESME will help the Commission respond adequately to the existing market uncertainty regarding the role of rating agencies.

Yours sincerely,

*Best regards,*

David Wright

Contact: Piotr Plizga, Tel: +32-2-29 88772, E-mail: [Piotr.Plizga@ec.europa.eu](mailto:Piotr.Plizga@ec.europa.eu)  
Enclosure: Mandate to ESME for advice: Role of credit rating agencies  
c.c.: ESME members

## **Mandate to ESME for advice**

### **Role of credit rating agencies**

This mandate requests ESME's advice on certain issues concerning the role of credit rating agencies (CRAs) and the importance of ratings in the financial markets, and in particular in the field of structured finance.

Following the recent developments in the field of CRAs (e.g. sub-prime market crisis, new US Act on CRAs) the Commission services would like to request advice from ESME on specific issues related to the regulation of CRAs.

This mandate is to ensure that the Commission has adequate technical background to be able to complete its examination of the rating process following the recent developments in the financial markets.

#### **1. BACKGROUND AND LEGAL FRAMEWORK**

CRAs play a vital role in global securities and banking markets. It is essential, therefore, that they consistently provide ratings which are independent, objective and of the highest possible quality.

The European Commission adopted on 23 December 2005 a Communication setting out its approach to CRAs<sup>1</sup>. Against the background of various financial scandals in the US and the EU and following the resolution on CRAs adopted by the European Parliament in February 2004, the Commission has considered very carefully whether or not fresh legislative proposals are required to regulate the activities of CRAs. One of the central principles of "Better Regulation" is that legislative solutions should be applied only where there is a market failure and where legislation is strictly necessary to address that market failure and to achieve public policy objectives. In line with advice received from the Committee of European Securities Regulators (CESR) in March 2005, the Commission decided not to present new legislative proposals in the area of CRAs considering that the existing financial services directives applicable to CRAs – combined with self-regulation by the CRAs on the basis of the International Organisation of Securities Commissions (IOSCO) Code – would provide an answer to all the major issues of concern raised by the European Parliament. The Commission stipulated clearly in its Communication that it would monitor the developments in this area very carefully, with the help of CESR which would monitor the implementation of the IOSCO Code by

---

<sup>1</sup> Communication from the Commission on Credit Rating Agencies COM (2006) OJ 11.3.2006 and the Annex including IOSCO Code of Conduct Fundamentals for Credit Rating Agencies may be found under: [http://europa.eu.int/comm/internal\\_market/securities/agencies/index\\_en.htm](http://europa.eu.int/comm/internal_market/securities/agencies/index_en.htm)

the CRAs and report to the Commission on a yearly basis. Moreover, the Commission indicated that it might consider introducing new proposals if it became clear that compliance with EU rules or the IOSCO Code was unsatisfactory or if new circumstances were to arise – including serious problems of market failure or fresh developments in other parts of the world. Finally, the Commission noted that there was no clear indication of any anti-competitive practices in this industry but any evidence to the contrary would be examined thoroughly.

Following the recent developments in the field of CRAs (e.g. sub-prime market crisis, new US Act on CRAs) the Commission services would like to request advice from ESME on specific issues related to the regulation of CRAs.

## **2. CONSULTATION AND SOURCES OF ADVICE**

In parallel to this request advice is sought from the Committee of European Securities Regulators (CESR). A copy of our letter to CESR for advice has been made available on CESR's website.

ESME should also note that the US Congress, Securities and Exchange Commission (SEC) and IOSCO (in cooperation with Committee on the Global Financial System) are looking into the rating business. ESME should be aware of what is being publicly discussed and proposed. The Commission services also recommend that ESME invite practitioners from the rating business (present and former) and users of ratings in preparation of their report.

## **3. THE PRINCIPLES TO WHICH ESME SHOULD HAVE REGARD**

As regards its working approach, ESME is invited to take account of following principles:

- The principles set out in the Decision<sup>2</sup> establishing ESME;
- ESME should provide comprehensive advice on the matters described below;
- ESME should address to the Commission any questions which arise in the course of its work.

## **4. QUESTIONS IN RELATION TO WHICH ADVICE IS SOUGHT**

### General questions

ESME is asked to:

- provide its views on the role of CRAs and the importance and meaning of ratings in the financial markets, and in particular in the field of structured finance.

---

<sup>2</sup> See Decision 2006/288/EC, OJ L 106, 19.4.2006, p. 14,  
[http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_106/l\\_10620060419en00140017.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_106/l_10620060419en00140017.pdf)

- to look into the functioning of the (self) regulatory framework in the EU for CRAs, taking into account the new US Act Credit Rating Agency Reform Act of 2006 which entered into force in June 2007.

#### Specific questions

ESME is asked to consider the following specific questions and provide practical evidence regarding these issues of concern. ESME is also requested to provide its views for improvement of the rating process in respect of any deficiency identified.

- (1) Does ESME consider that the particular oligopolistic market structure influences competition amongst the CRAs in a way that may have a negative impact on the quality / integrity of the rating process?
- (2) What are ESME's views on the quality of ratings and does ESME consider that rating methodologies are sufficiently robust, in particular for structured finance ratings? Does ESME consider that CRAs staff's understanding of the rapidly and growing complex structured finance market is satisfactory?
- (3) Does ESME consider the rating methods, including the assumptions within these methodologies, sufficiently transparent?
- (4) Have CRAs made sufficiently clear how the meaning of structured finance ratings differs from corporate ratings. If not, would it be desirable that CRAs make a clear distinction in terms of rating "labels" between corporate and structured finance ratings?
- (5) Does ESME consider that the level of transparency regarding rating changes should be improved? In particular, are the reasons for rating changes sufficiently clear?
- (6) As regards the timeliness of rating changes, does ESME consider that CRAs have adequate resources for ongoing surveillance of existing ratings? Does ESME consider that CRAs need to improve the timeliness of rating decisions and, is the cycle of review appropriate and adequate for structured finance in view of the particular market dynamics?
- (7) Does ESME believe that rating analysts should be required to obtain a formal qualification in credit rating according to agreed standards before practicing as such?
- (8) Does ESME believe that the rating agencies respond adequately to the increased risks of future default arising from changed market circumstances which reflect in current delinquencies and foreclosures?
- (9) Does ESME believe it is appropriate that a rating agency is not obliged to verify information via due diligence or to conduct an investigation or review to establish the integrity of core information used in the rating process?
- (10) Should rating agencies put in place more automated and objective systems, based for example on the changing value of underlying assets / cashflows, to facilitate more dynamic rating?

- (11) Should rating analysts be required to serve "cooling off" period before working for a client (i.e. "gardening" leave)?
- (12) How does ESME believe that risks of conflicts of interest arising in the interaction between issuers/arrangers and CRAs might be more effectively mitigated? In particular, for example, does ESME believe that the independence of the rating assessment process should be underpinned by having a separate and direct reporting line to a committee of independent directors on the rating agency boards?
- (13) Are there any other issues related to the role of CRAs ESME would like to raise?

## **5. DUE DATE**

ESME's advice is sought by 31<sup>st</sup> May 2008.