

Improved supervision on Credit Rating Agencies



A new European supervisory authority – the European Securities and Markets Authority (ESMA) will be entrusted with exclusive supervision powers over EU Credit Rating Agencies as early as 2011 if the supervisory package creating the new Supervisory Authorities and the European Commission's proposal of 2 June are adopted by the European Council and the European Parliament.

Credit Rating Agencies

Credit Rating Agencies (CRAs) issue opinions on the creditworthiness of companies, governments and sophisticated financial structures. They are seen to have contributed to the financial crisis by underestimating the risk that the issuers of certain more complicated financial instruments may not repay their debts. As they gave the highest possible ratings to many of those complex instruments, inexperienced investors felt encouraged to purchase them without properly assessing the risks. The financial crisis exposed many of these shortcomings in rating practices. Better supervision became mandatory.

Credit Rating Agency Regulation in 2009

After the financial crisis hit, the Commission reacted swiftly; a Credit Ratings Agency Regulation was adopted in April 2009. Following this, at the June 2009 European Council, inspired by the recommendations of the De Larosière report¹, Heads of State and Government called upon the Commission to come forward with proposals on a centralised system for supervision of CRAs at EU level. The European Parliament equally requested centralised supervision for CRAs.

Need for a supervisory framework

In 2009, when the current CRA Regulation was negotiated, an interim solution was found for European supervision; by creating colleges to carry out this task and created a single entry point (CESR). However, the 2009 CRA Regulation already stated in a recital that the college structure should only be a preliminary solution and advocated a more consolidated supervisory framework in the mid term. With the European Commission's proposal for ESMA, the next step towards such a framework has been taken.

ESMA's remit

ESMA will be endowed with a set of supervisory powers, such as requesting relevant information, asking for oral explanations, examining records and conducting on-site inspections. Where it detects a breach, ESMA will be empowered to take the necessary supervisory measures, taking into account the nature and seriousness of the breach. These measures could range from the temporary prohibition of issuing credit ratings to the withdrawal of

the registration altogether. In addition, in the case of intentional or negligent breaches, ESMA may request the Commission to impose a fine or a penalty payment on the CRA that has committed the breach. These sanctions must be dissuasive and proportionate to the nature and seriousness of the breach and take into account the economic capacity of the CRA concerned. Close cooperation between ESMA and the competent national authorities is envisaged. National authorities will have to assist ESMA in investigations and on-site inspections and should notify ESMA of suspected breaches. ESMA can also delegate some supervisory tasks to them.



¹ The High Level group on Financial Supervision in the EU, 'Report', Brussels, 25 February 2009, available on http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf on 20 June 2010

Advantages

Advantages of this new system for supervision exist for CRA's as well as for their users. It would ensure:

- A single point of contact for registered Credit Rating Agencies;
- A more consistent application of the rules for CRAs throughout the EU;
- Significant efficiency gains due to a shorter and less complicated registration and supervisory process.

Credit rating agencies will operate in a much simpler supervisory environment, with only one centralised supervisory authority – ESMA – being responsible for their registration and supervision at EU level. The new supervisory structure also means that decisions in individual cases will take less time and the risks of incoherent application of legislation EU-wide or conflicting competences between supervisors will be eliminated.

The *users of ratings* will benefit from a higher quality of ratings and a greater transparency of rating activities. They will be more effectively protected as there will be a coherent and consistent application of the CRA Regulation throughout the EU. Breaches of the CRA Regulation can be reported to a single supervisory authority in Europe, specialised in dealing with cases involving rating activity and fully equipped to pursue cross-border cases.

Obligations for issuers of financial instruments

The Commission's proposal also introduces an obligation for issuers of structured finance instruments to provide access to information. Not only to the rating agency they appoint, but also to other rating agencies interested in providing unsolicited ratings. This obligation, already implemented in some third-country jurisdictions, (among which the USA is included), is expected to enhance competition between credit rating agencies, to improve the transparency and the quality of ratings and to counterbalance the risks of conflicts of interest under 'the issuer-pays model'.

Other issues concerning CRA's.

In addition, in the Commission Communication of 2 June on 'Regulating financial services for sustainable growth', the Commission has engaged itself to examine other issues related to CRA's, such as their business structure, the reference to ratings in the legislation and the relationship between the rating activity and sovereign debt.

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