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**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN  
PARLIAMENT**

**on the feasibility of a network of smaller credit rating agencies**

{SWD(2014) 146 final}

# **REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT**

## **on the feasibility of a network of smaller credit rating agencies**

### **1. Introduction**

Credit Rating Agencies (CRAs) play an important role in today's capital markets in terms of access to capital and long term financing of the world's economy. Since a credit rating reflects the rating agency's opinion, as of a specific date, of the creditworthiness of a particular state, company, security, or obligation, it represents an important input to investors and other market participants influencing their strategic decision-making. The role CRAs played in the recent financial crisis illustrates their importance for the globalised financial markets, with credit ratings affecting securities markets in many ways, including an issuer's access to capital, the structure of transactions and the ability of fiduciaries and others to make particular investments. This is even more important for long term investments, where CRAs have an impact on the way savings are channelled to long-term investment needs<sup>1</sup>.

A number of distinctly smaller CRAs have emerged in Europe (their number has further increased after the introduction of European legislation on CRAs in 2009<sup>2</sup>), operating with a clear focus on specific industry sectors (e.g. the insurance industry), financial market segments (e.g. municipal bonds) or specific geographical area, thus responding to specialised market needs.

The established regulatory framework of the Regulation on credit rating agencies in the EU requires them to be registered, authorised and supervised by the European Securities and Markets Authority (ESMA). The legislation also subjects them to stringent independence rules as a pre-condition for the provision of rating services. Compliance with this regulatory regime has played a role of quality assurance for their services on the market and has, in this way, helped them to evolve over time as serious market actors. Nevertheless, despite their good potential to grow, to date these new market players often remain small in terms of scope and geographical orientation.

#### **1.1. Objective of the report**

Improving the conditions for effective competition on the concentrated market for credit rating agencies and thereby creating the pre-conditions for the emergence and growth of new market players is a key objective of the policy work of the European Commission in this area.

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<sup>1</sup> See also Green Paper Long-term financing of the European Economy, COM(2013) 150 final, [http://ec.europa.eu/internal\\_market/finances/financing-growth/long-term/index\\_en.htm](http://ec.europa.eu/internal_market/finances/financing-growth/long-term/index_en.htm)

<sup>2</sup> 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, p.1, hereafter: CRA Regulation

This objective is also well enshrined into the efforts made at international level (G20, Financial Stability Board (FSB) and the International Organisation of Securities Commissions (IOSCO)) to enhance transparency and strengthen the competition in the credit rating agencies' market<sup>3</sup>.

With the aim to further increase competition, the European Commission envisaged additional measures in its proposal for a third CRA Regulation, which has recently been adopted and entered into force,<sup>4</sup> hereafter referred to as the CRA III Regulation. Pursuant to Article 39b(3) of the CRA Regulation, "the Commission shall, by 31 December 2013, submit a report to the European Parliament and to the Council regarding the feasibility of a network of smaller credit rating agencies in order to increase competition in the market. That report shall evaluate financial and non- financial support for the creation of such a network, taking into consideration the potential conflicts of interest arising from such public funding. In light of the findings of that report and following ESMA's technical advice, the Commission may re-evaluate and suggest amending Article 8d<sup>5</sup>" of the CRA III Regulation.<sup>6</sup>

The overall objective of an establishment of such a network aims at strengthening the smaller CRAs and thereby facilitating their growth to become more competitive market players.

Section 2 of the report identifies and analyses the feasibility of all possible policy options, through which such network could be established in order to fulfil the above stipulated objective. The analysis covers operational and financial aspects of such establishment.

Section 3 draws some conclusions based on the findings in section 2 and proposes short as well as medium/ long term steps to achieve the overall objective.

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<sup>3</sup> Following the G20 communiqué resulting from its 4-5 November 2012 meeting encouraging IOSCO to work further "to enhance transparency of and competition among credit rating agencies", IOSCO reported to the G20 on "Transparency and Competition among Credit Rating Agencies" in April 2013 as well as its ongoing work (available at: [http://www.iosco.org/library/briefing\\_notes/pdf/IOSCOBN01-13.pdf](http://www.iosco.org/library/briefing_notes/pdf/IOSCOBN01-13.pdf)). In addition, IOSCO launched the revision of the Code of Conduct Fundamentals for Credit Rating Agencies of December 2004 (available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>) foreseen to be concluded by the summer of 2014, in order to reflect on those issues. In August 2013, the FSB submitted to the G20 a Progress Report on its work with regard to Credit Rating Agencies, also covering the work done by IOSCO in this area.

<sup>4</sup> Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 146, 31.5.2013, p.1

<sup>5</sup> Article 8d CRA Regulation on the use of multiple CRAs provides that:

"1. Where an issuer or a related third party intends to appoint at least two credit rating agencies for the credit rating of the same issuance or entity, the issuer or a related third party shall consider appointing at least one credit rating agency with no more than 10 % of the total market share, which can be evaluated by the issuer or a related third party as capable of rating the relevant issuance or entity, provided that, based on ESMA's list referred to in paragraph 2, there is a credit rating agency available for rating the specific issuance or entity. Where the issuer or a related third party does not appoint at least one credit rating agency with no more than 10 % of the total market share, this shall be documented.

2. With a view to facilitating the evaluation by the issuer or a related third party under paragraph 1, ESMA shall annually publish on its website a list of registered credit rating agencies, indicating their total market share and the types of credit ratings issued, which can be used by the issuer as a starting point for its evaluation.

3. For the purposes of this Article, total market share shall be measured with reference to annual turnover generated from credit rating activities and ancillary services, at group level."

<sup>6</sup> Article 39b(3) CRA Regulation

## 1.2. Stakeholder Consultation

In the process of analysing the feasibility of a network of smaller credit rating agencies the Commission established a comprehensive stakeholder consultation process in order to analyse the concerns of smaller CRAs.

A first meeting on this subject took place in January 2013 with the members of the European Association of Credit Rating Agencies (EACRA), an association of smaller credit rating agencies, to better understand the willingness among stakeholders to establish a network of smaller credit rating agencies. The issue of the creation of a network of smaller credit rating agencies was also discussed at meetings with individual representatives of smaller CRAs.

Furthermore, on 2 July 2013 the Commission organised a Roundtable with smaller CRAs in order to obtain detailed views on the feasibility of a network of smaller CRAs. The Roundtable was attended by representatives from 13 CRAs, EACRA, a representative from the ESMA and the European Economic and Social Committee<sup>7</sup>. The Roundtable allowed for a fruitful discussion with participants on market developments and trends for smaller CRAs relevant for the purpose of the Commission report. Useful feedback was also provided to the Commission through written contributions before and after the Roundtable.

In addition, the Commission requested and received technical advice on the report from ESMA, which offered valuable input for the establishment of this report<sup>8</sup>.

## 1.3. Definition of smaller CRAs for the purpose of this report

In accordance with the CRA Regulation, this report assesses the feasibility of a network of "smaller credit rating agencies".

The CRA Regulation contains a number of thresholds regarding turnover, number of employees and market share in provisions which aim to increase competition on the market for smaller CRAs (described in further detail below). However, the Regulation does not contain a definition of "smaller credit rating agencies" as such.

For the purpose of this Report, based on the analysis of the market provided by ESMA in its technical advice, 19 out of 22 registered CRAs and the 2 certified CRAs (see Annex for the full list of registered and certified CRAs) are considered "smaller credit rating agencies". This assessment takes into account the large divergence between the "larger" and "smaller" CRAs with regard to the following factors: number of employees, scope of operations (as regards the types of ratings issued), group structure and financial turnover.

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<sup>7</sup> See minutes from the roundtable at: [http://ec.europa.eu/internal\\_market/rating-agencies/docs/130702\\_minutes\\_en.pdf](http://ec.europa.eu/internal_market/rating-agencies/docs/130702_minutes_en.pdf)

<sup>8</sup> ESMA, "Technical Advice on the feasibility of a network of small and medium-sized CRAs", 21 November 2013, available at: [http://www.esma.europa.eu/system/files/2013-1703\\_technical\\_advice\\_on\\_the\\_feasibility\\_of\\_a\\_network\\_of\\_small\\_and\\_medium-sized\\_cras\\_0.pdf](http://www.esma.europa.eu/system/files/2013-1703_technical_advice_on_the_feasibility_of_a_network_of_small_and_medium-sized_cras_0.pdf)

## **2. Feasibility of a network of smaller CRAs**

The Impact Assessment accompanying the CRA III Regulation made an initial analysis on the potential impact of the creation of a network of smaller CRAs on competition in the CRA market. It concluded, based on a stakeholder consultation, that there is some support for the creation of such a network. Building on this work within the preparation of this Report, the European Commission has further assessed the added value of the creation of a network as well as the different possible options of the type of network which would best serve its purposes and be feasible to implement.

Taking the above into consideration, two types of networks have been envisaged, depending on the scope and nature of the proposed cooperation. The pros and cons of each option are presented below together with reflections on the logistical side of its implementation.

### **2.1. An integrated network**

An integrated network would have a wider scope and deeper level of cooperation. The Commission has assessed, with contributions from representatives of smaller CRAs, a number of possible areas which could be covered.

As a result, the following issues have been identified by this assessment as areas where an integrated network could potentially have an added value: the development of a common data platform for underlying information used for developing ratings, design and use of common methodologies, sharing of expert knowledge and best practices on a wide range of topics such as internal controls, investor education, communication, methodologies and legal compliance.

However, the feedback received from smaller CRAs has been mixed with regard to the creation of such a network. At the Roundtable organised by the Commission, only a minority of participants were in favour of an integrated network, as described above an initially been put forward by the Commission for discussion.

The analysis of the option of an integrated network showed as well that there are number of obstacles for smaller CRAs to create a network with deepened cooperation. First of all, they often have very distinct business models and objectives, which makes it difficult to integrate such a large number of players under one umbrella. Furthermore, they operate in distinct market niches and apply distinct methodologies and strategies in terms of geographical scope. This would make it difficult to create a network that fits their needs. Smaller CRAs which operate in a competitive environment consider it also difficult to participate in a network with competitors having the same geographical and/or niche market focus. Therefore, it was pointed out by stakeholders that networks (including networks composed of a limited number of smaller CRAs) would emerge from market forces rather than be formally established by the European Commission.

In addition, the establishment of such an integrated network at this stage could be considered a big investment with no clearly visible returns. A clear and viable business case for networks of CRAs to perform as separate entities on the market is absent at this stage. The introduction of a

special regime for networks, allowing the participants in them to be registered with ESMA as CRAs under a new network brand name, while maintaining their individual brand names, could facilitate the process. The current regulatory regime allows for networks to be established but only under the same brand name. Such a special regime could facilitate the establishment of *ad hoc* networks by several CRAs pooling resources to issue ratings in specific rating class or geographical area.

Finally, there is a risk that any such integrated network could lead to increased anti-competitive behaviour. This would be contrary to the European Union's objectives to enhance diversity in the rating industry. Moreover, EU competition law would under all circumstances need to be respected. The scope and type of information exchange would need to fully respect Article 101 of the Treaty on the Functioning of the European Union (TFEU)<sup>9</sup>.

Concerning the establishment of such a fully integrated network of smaller CRAs, this would require extensive financing and corresponding project follow-up by the European Commission to get the project "up and running". Depending of the scope of the network the financing, based on the participation of 15 CRAs, were estimated in the range of EUR 900.000-1.950.000 annually<sup>10</sup>.

If it were to be decided to pursue such an initiative, it could potentially fit within one of the two programmes which are part of the multiannual financial framework of 2014-2020. More specifically, the programmes "Horizon 2020"- or "COSME"- could cover a possible initiative. A pre-condition for successful project funding would be strong ownership from industry stakeholders to assist in drafting the project request to be submitted to one of these EU programmes, wherein the scope and design of the project must be clearly outlined. Granting of such financing is conditional on the positive assessment by the respective Commission Service of the project application, in line with the legal requirements for such applications. Such an EU-funded project would equally require extensive follow up from the European Commission with respect to the submission of the funding application and consequent implementation of the project. In addition, the Commission was also required to evaluate in this report the potential conflict of interest arising from a financial and non-financial support for each policy option. However, as far as this particular option is concerned the analysis did not cover such assessment taking into account that the option was rejected because of the several major obstacles identified together with competition concerns regarding the type of information, which could be potentially exchanged. Such analysis is made only for the preferred policy option.

## **2.2. A cooperative network**

The creation of a cooperation network was assessed as an alternative to the integrated network approach described above. This would entail a lighter form of cooperation. . It could take the form of a forum for smaller CRAs, which would enable the establishment of a structure for regular exchange and cooperation among smaller CRAs.

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<sup>9</sup> See also Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal cooperation agreements, OJ C 11, 14.01.2011, pages 1-72, from paragraph 55.

<sup>10</sup> Impact Assessment accompanying the CRA III legislative proposal, Annex X, p. 161

The analysis aimed at showing to what extent this forum could be a platform to advance issues of interest to smaller CRAs as well as exchange of information and best practices, specifically on the potential difficulties in implementation of the CRA III Regulation and on strategic issues of common importance. An assessment was made as well as regards the potential of such a forum to contribute to the reduction of barriers to entry and enhanced growth for smaller CRAs as presented in Section 3 by contributing to the assessment of the impact of the CRA III measures and potentially identify additional means/ tools to implement in this area. It was also considered whether a cooperation network could be useful in order to find further ways to facilitate the disclosure of information by issuers to CRAs with a view of facilitating issuance of unsolicited credit ratings for corporate issuers, including smaller issuers. The work of the network could also cover discussions around lifting barriers to cross-border growth for smaller CRAs as regards non-EU countries.

The Commission could participate in the work of the network for example by setting the agenda and chairing the meetings. In this way the cooperation network could also function as a regulatory dialogue between smaller CRAs and the European Commission. This dialogue would provide the Commission with feedback on potential problems smaller CRAs are facing and be instrumental to the further Commission Reports to be presented as a follow-up of the CRA III Regulation. Specifically, the CRA III Regulation requires the Commission to assess the requirement to use a small CRA when employing more than one CRA on a “comply or explain basis”, the extension of the rotation rule to other instruments and need for additional initiatives to promote competition in the rating market.<sup>11</sup>

Reflecting on how to progressively deepen or widen the scope and nature of cooperation was also considered in the context of the work of a potential network. This would allow the network to evolve over time, as needed.. In this respect, the network could aim at identifying the potential obstacles for developing further cooperation among smaller CRAs and make proposals to address these obstacles. However, as mentioned above, EU competition law would have to be fully respected at all times.

From the feedback of discussions with smaller CRAs, although they did not seem fully against a cooperative network they have indicated that they are mainly interested in an ongoing regulatory dialogue with the Commission to discuss proportionate regulation which takes into account the specificities of smaller CRAs.

With regard to the format of meetings, the network could work in a plenary format, while working groups could be established to focus on individual topics and which subsequently report to the plenary.

The financial support needed to set up the cooperation network would be limited to the organisation of meetings. The Commission could ensure the organisational and logistical support of the forum.

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<sup>11</sup> Article 39(4) and (5)

### **3. Conclusions and next steps**

The analysis of the feasibility of the options for the creation of a network of smaller CRAs has identified multiple market obstacles for the establishment of an integrated network as well as some obstacles limiting the potential scope of a cooperation network. In addition, the stakeholder consultation has revealed that there is no support and ownership among industry representatives to establish, under the current conditions, any form of network of smaller CRAs. Smaller CRAs have rather expressed the need for a structured dialogue or forum with the European Commission to discuss the state of the CRA market and regulation, in particular, issues affecting smaller CRAs. Therefore although the establishment of a cooperation network with limited exchange of information could be feasible, it seems not to fully correspond to the identified needs of smaller CRAs.

Furthermore, as also presented in the Report, a set of measures has already been introduced with the entry into force of the CRA III Regulation which aims at boosting competitiveness and supporting the growth of smaller CRAs on the rating market. However, a number of these measures require further delegated and implementing legislation to be drafted by the European Supervisory Authorities and adopted by the Commission. This process is currently ongoing. At the same time, for those measures which have become applicable as of the date of entry into force of the CRA Regulation on 20 June 2013, the time period since then is not sufficiently long to allow an assessment of the effect of these measures on competition.

Such an assessment of the impact of these measures should be carried out before the establishment of any form of cooperation of smaller CRAs could be properly assessed and respective policy option proposed. Once the impact of these measures and thus the outstanding needs of smaller CRAs can be analysed, this will, in turn, allow for considering if a network is still a viable option and in a positive case scenario will help to determine its scope and type, taking into account competition law considerations. At the same time, the setup of a regulatory dialogue with the industry can contribute and facilitate this process.

Taking this into account, this Report proposes a step by step assessment of the need to establish a network within the medium/long term.

#### **3.1 Short term policy options**

The Commission proposes as an alternative to creating a network, the establishment of a regulatory dialogue as the most proportionate solution within the short term. The analysis of the market and stakeholder's views have shown that there is an identified need among smaller CRAs at this stage for the creation of such form of exchange on the state of the CRA market and in particular issues that affect smaller market players. This dialogue could consist of a periodic follow up of market developments in the rating industry and allow discussing on regulatory issues relating to the CRA regulation.

Such regulatory dialogue could take the form of one or more events per year, where stakeholders will have the opportunity to express their views of the state of the market and discuss with the

European Commission regulatory issues of particular interest for smaller CRAs in a similar way as described under the option of cooperation network.

### **3.2 Medium/ long term policy options**

Reflecting on the results of the work of the regulatory dialogue and the assessment of the effect of the measures adopted under the CRA III Regulation, the Commission Services will at a later stage assess the added value of a network of smaller CRAs and if considered feasible define the measures to take in order to create the regulatory framework for networks to function effectively.