



EUROPEAN CENTRAL BANK

EUROSYSTEM

COMMISSION'S DRAFT DIRECTIVE/REGULATION ON CREDIT RATING AGENCIES

EUROSYSTEM CONTRIBUTION TO THE PUBLIC CONSULTATION

INTRODUCTION

On 31 July 2008 the Commission services published a draft legislative text for a consultation concerning the conditions for the authorisation, operation and supervision of credit rating agencies (CRAs) ("the draft proposal"), with the intention of issuing a formal legislative proposal in autumn 2008 in the form of either a regulation or a directive.

This note provides the preliminary views of the Eurosystem regarding the main issues raised in the draft proposal. This is without prejudice to the opinion adopted by the ECB when it is formally consulted on the Commission's proposal pursuant to Article 105(4) of the Treaty.

The note is structured as follows: Section 1 briefly describes the current policy debate concerning CRAs and the Eurosystem's interest therein. Section 2 contains the Eurosystem's comments on the draft proposal.

I BACKGROUND

I.1 THE MARKET TURMOIL AND THE CURRENT POLICY DEBATE CONCERNING CRAs

Since the outbreak of the financial market turmoil, CRAs have been widely criticised for their initial ratings of structured finance securities that did not reflect the true risks inherent in those securities. Rating agencies' models foresaw neither the high level of delinquencies that materialised in US mortgage-backed securities nor the inadequate design of liquidity support mechanisms for securitised transactions, which failed as money market conditions worsened after the Asset-Backed

Commercial Paper (ABCP) market came under stress. In addition, critics pointed to poor surveillance of the deteriorating dynamics of the collateral pools backing mortgage-backed securities that were already visible before the major dislocations in asset-backed securities markets (ABS) occurred in mid-2007. Critics have also pointed to perceived conflicts of interest resulting from the business model followed by rating agencies according to which they provide advice to issuers and financial intermediaries in the structuring stages of a transaction, as well as their practice of being paid directly by the issuers or originators of securitised transactions.

The Report of the Financial Stability Forum (FSF) published on 7 April 2008 summarised the main sources of concern about the CRAs' performance: "weaknesses in rating models and methodologies; inadequate due diligence in monitoring the quality of the collateral pools underlying rated securities; insufficient transparency about the assumptions, criteria and methodologies used in rating structured products; insufficient information provision about the meaning and risk characteristics of structured finance ratings; and insufficient attention to conflicts of interest in the rating process."¹ The FSF also presented a number of recommendations for further action relating to: the quality of the rating process; differentiated rating and expanded information on structured products; the CRA assessment of underlying data quality; and the uses of ratings by investors and regulators.

Recognition of the abovementioned issues led to a number of initiatives at various levels. At

¹ Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 7 April 2008, p. 8.

international level, the IOSCO reviewed its Code of Conduct for CRAs on May 2008 with the aim of strengthening its guidelines on the quality and integrity of ratings, as well as on the independence of CRAs and avoidance of conflicts of interest (“the revised IOSCO Code”). In the United States, the Securities and Exchanges Commission (SEC), which is responsible for the oversight of CRAs, recently proposed amendments that would impose, in particular, additional requirements on rating agencies in order to address concerns about the integrity of their credit rating procedures and methodologies in the light of their role in determining credit ratings for securities collateralised by or linked to sub-prime residential mortgages and to reduce undue reliance on the CRAs’ ratings².

In Europe, the Committee of European Securities Regulators (CESR), at the request of the Commission, prepared a report in May 2008 on the process of rating structured finance instruments in the context of the recent turmoil, in which some specific actions to improve the conduct of CRAs were pointed out. On 31 July 2008, the European Commission published two consultation papers concerning: a) a complete regulation framework for CRAs; and b) policy options to address the problem of excessive reliance on ratings³. The first of these consultation papers includes the abovementioned draft proposal.

I.2 THE EUROSISTEM’S INTEREST IN THE POLICY DEBATE REGARDING REGULATORY MEASURES ON CRAs

The Eurosystem has a keen interest in the policy debate concerning possible regulatory measures on CRAs for the following reasons.

First, CRAs play an important role in market functioning by reducing informational asymmetries between issuers and investors, thus contributing to a more efficient allocation of risks and resources among market participants.

Second, as events during the market turmoil showed, the perceived existence of shortcomings in the rating activity performed by CRAs may erode market confidence and might adversely affect financial stability.

Third, the ECB/Eurosystem is directly concerned with the services that rating agencies provide in the context of Eurosystem tasks and obligations with regard to both the conduct of monetary policy operations and asset management operations. Article 18(1), second indent of the ECB/ESCB Statute provides, in particular, that the ECB and the national central banks may “conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral”. In this respect, one important eligibility criterion of assets, for the purpose of monetary policy operations, is that they must meet high credit standards. In the assessment of credit standards of eligible assets, the Eurosystem takes into account, *inter alia*, credit assessments deriving from different sources, including CRAs that are defined as “external credit assessment institutions” (ECAIs). The latter are subject to general acceptance criteria, complemented by a multi-annual performance monitoring process⁴ in accordance with the conditions published in the ECB Guidelines on monetary policy instruments and procedures of the Eurosystem⁵.

2 See SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations (available at <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>).

3 See the consultation papers at: http://ec.europa.eu/internal_market/consultations/2008/securities_agencies_en.htm.

4 See Annex 1.

5 See the Guideline of the ECB of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7), OJ L 310, 11.12.2000, p. 1, as amended (available at www.ecb.int).

2 THE EUROSYSTEM'S COMMENTS ON THE COMMISSION'S DRAFT PROPOSAL

2.1 GENERAL COMMENTS

According to the consultation document, the policy response proposed by the Commission is likely to involve regulatory measures, following the “manifest failure” of self-regulatory efforts to ensure high standards of independence, integrity and professional diligence. The draft proposal includes a set of legal requirements for CRAs to comply with subject to an independent external oversight, with the aim of ensuring that CRAs: (i) avoid and manage any conflict of interest; (ii) apply a high standard for the quality of the rating methodology and the ratings; and (iii) increase the transparency of their activities.

The Eurosystem concurs with the Commission that, given the central role played by CRAs in financial markets, regulatory action may be needed to correct market failures as shown by the recent market turmoil and to address identified problems for which self-regulatory actions on the part of CRAs have been ineffective. The Eurosystem also welcomes the Commission's stated aim to ensure as far as possible close alignment with international regulatory standards given the current market structure of the credit rating industry, which is dominated by a few players (see Annex 2). Any regulatory regime concerning CRAs should therefore be tailored to the need to ensure further convergence and coordination at international level. In particular, the contents of the provisions in the revised IOSCO Code should serve as the basis for the European requirements as they represent a suitable foundation for an internationally coordinated approach.

In general, any regulatory initiative at EU level concerning CRAs should have the following objectives. First, in order to allow market participants to better monitor the ratings given by CRAs, any regulatory initiative should increase the level of transparency about the issuance of ratings and the ongoing surveillance

of those ratings. Improved disclosure standards, which should also include information on the collateral assets underlying structured products, would allow better comparison of CRAs' rating assessments, thereby enabling more competition and innovation in the sector by creating opportunities for peer review and eliminating possible competitive disadvantages owing to the lack of access to underlying collateral information. Second, as correctly mentioned in the Commission's consultation document, the regulatory framework should not interfere with the content of ratings for which the CRAs would retain full legal responsibility and this should be clearly stated in the final proposals. At the same time, it should aim to ensure that the rating process meets adequate standards of quality and integrity. In particular, from a financial stability perspective, it is of the utmost importance that ratings are issued using models and processes that are based on sound assumptions that avoid excessive volatility of ratings, which could result in a sharp repricing of assets and impair market confidence. The regulatory framework should also facilitate the conduct of stress tests by users on key model parameters and provide for the disclosure by CRAs of the economic assumptions underlying their rating of structured products⁶.

Third, the integrity and independence of CRAs should be safeguarded by ensuring that conflicts of interest are either avoided or properly addressed within a transparent regulatory framework, which would be properly enforced.

The draft proposal appears to take into appropriate consideration the abovementioned objectives and is therefore broadly welcomed by the Eurosystem.

⁶ See Report of the Committee on the Global Financial System, CGFS Papers n. 32, July 2008.

2.2 THE COMMISSION'S DRAFT PROPOSAL ON THE AUTHORISATION AND SUPERVISION OF CRAs

The draft proposal suggests the adoption of a set of rules introducing a number of substantive requirements that CRAs will need to respect for the authorisation and exercise of rating activity. Furthermore, the Commission proposes two possible options for consultation with regard to the authorisation process and supervision of CRAs. In general, it is noted that, as the financial markets turmoil highlighted the weaknesses of CRAs' processes in structured finance only, the Commission may consider providing an alternative less stringent treatment for local rating agencies, which mainly deal with corporates issuances. For instance, some requirements could be waived for local agencies under the responsibility of the national authorities in charge of implementing the directive. This would allow some flexibility, which might also help to maintain diversity in the population of CRAs, ensuring a diversity of opinions.

Option 1 (national authorisation and supervision) would be based on a strong coordination role for the CESR resting on a home country approach to authorisation and supervision. CESR members would agree on a national supervisor to be the competent home Member State authority responsible for deciding on the authorisation request and for supervising the applicant CRA. A CRA would submit its application to the CESR. The designated home Member State authority would also grant the authorisation and be responsible for taking supervisory measures and applying sanctions, when necessary, although other competent authorities would retain the competence and right to take action, in particular, to protect interests on their territory.

Option 2 (Community authorisation) would be based on the establishment of a Community Agency (either the CESR or a new Agency) that would be responsible for the authorisation of CRAs. The competence for supervising

and sanctioning the activities of CRAs would remain with the national competent authorities, which could decide to delegate certain tasks or responsibilities to the Agency.

The Eurosystem notes that the establishment of a sound and efficient structure for authorisation and supervision of CRAs across Europe is of key importance. The choice of structure would need to address the particular nature of the rating industry, which is highly concentrated, with a few players dominating the market. In addition, the new entry requirements should not unduly restrict competition from new entrants or consolidate the incumbents' advantages.

The Commission pointed out in its draft proposal that a number of important provisions of the draft proposal will need to be introduced depending on which of the above policy options is chosen⁷. The Eurosystem notes that the Commission did not discuss in its consultation document the legal basis (or legal bases) envisaged for the draft proposal and the type of the legal act(s) which would be proposed by the Commission. Since a number of the proposed provisions might be substantially modified, only the following preliminary considerations regarding the two options proposed by the Commission could be addressed.

First, in general, a "single-entry point" solution, whereby a single entity would treat in a consistent way all the different rating agencies, seems preferable as far as both authorisation and ongoing supervision is concerned. In the light of the structure of the rating industry, the most efficient solution would be to have a single entity to perform these tasks. However, the creation of a new EU agency for the authorisation of very few CRAs appears to be an unnecessarily costly solution. Moreover, a framework in which an EU agency is tasked with authorisation while ongoing supervision is allocated to national supervisors (which should coordinate among themselves), as proposed

⁷ See Part I, Introductory remarks, p. 4 of the consultation document.

under option 2, would further increase the complexity of the regulatory structure, without any recognisable benefit.

Second, the Commission may take into account the positive experience of the recognition of CRAs as external credit assessment institutions (ECAI) under the Capital Requirement Directive (CRD), where the Committee of European Banking Supervisors (CEBS) played a key role in ensuring the convergence of supervisory requirements and approaches within a decentralised framework.

Similarly, the CESR could play a role in the coordination of the competent national authorities as regards both the authorisation and the implementation of enforcement action. Having in mind the structure of the ECAI recognition process, a modified option 1 may be preferred according to which CRAs would be authorised and supervised by each individual national supervisor, following a joint assessment process and accompanied by a joint supervisory process.

Third, the Eurosystem understands that banking supervisors would retain the authority to recognise CRAs as ECAIs in accordance with the requirements laid down by the CRD. Therefore, careful consideration should be devoted to proper coordination arrangements in order to avoid a duplication of procedures and costly overlapping requirements when authorising CRAs and recognising ECAIs. Legal consistency should be ensured between the provisions of the CRD and those of the draft proposal.

Finally, the Eurosystem stresses that any coordination arrangement established for the regulation and supervision of CRAs should be designed to allow an appropriate level of involvement by the Eurosystem, given, as mentioned above, its keen interest from a financial stability perspective and the fact that it has already established a Eurosystem-wide framework – the Eurosystem Credit Assessment Framework – to monitor the performance

and activities of CRAs in the context of the implementation of monetary policy operations performed on the basis of the Treaty provisions (see Annex 1).

2.3 TECHNICAL COMMENTS ON SUBSTANTIVE REQUIREMENTS

This section contains some technical comments on the main substantive issues laid down in the draft proposal as regards the organisational requirements and operating conditions for CRAs. In general, it is proposed that a wider application of the Lamfalussy approach could be considered, whereby the draft proposal would focus on core principles, leaving technical details for Level 2 comitology measures.

2.3.1 CONFLICTS OF INTEREST

The Eurosystem fully shares and supports the objective of the draft proposal that ratings must be independent. This objective is concretely pursued by ensuring that CRAs “avoid situations of conflicts and manage adequately these conflicts” (recital 8). To this end, CRAs “should establish adequate internal policies and procedures to insulate those involved in the credit rating process from conflicts of interest” (recital 7); “disclose conflicts of interest in a complete, timely, clear, concise, specific and prominent manner” (recital 8); and have compensation arrangements that are “appropriate to ensure independence and avoid conflicts of interests” (recital 11). In accordance with these principles, the draft proposal adequately addresses the main concerns in relation to potential or actual situations of conflict of interest⁸.

The Eurosystem particularly appreciates the Commission’s approach of establishing core principles with which the internal policies and control systems of CRAs must comply rather than dictating prescriptive rules. However, Article 9(3) sub a) of the draft proposal deviates from this approach inasmuch as it sets a precise limit on the contribution of a rated entity to the annual revenues of a CRA, beyond which

⁸ Articles 9 to 11 of the draft proposal.

the CRA is not allowed to issue credit ratings in respect of that entity. The Eurosystem is of the opinion that such limits may, on the one hand, prevent CRAs from properly judging individual cases and, on the other, turn out to be ineffective, because quantitative limits could be easily circumvented. An alternative could be to consider introducing an obligation to publicly disclose the major contributors to CRAs' revenues, similarly to what is envisaged by the IOSCO's principles.

For similar reasons, the Eurosystem notes that, with regard to the provision of consultancy or advisory services, instead of the prohibition envisaged by Article 9() of the draft proposal, it could be ensured that CRAs dispose of an appropriate organisational structure, policies and procedures to adequately and fully separate the two lines of business and preserve the full independence of the credit rating process. Establishing appropriate segregation mechanisms is of the utmost importance, especially in the light of the possibility of providing "ancillary services" to be defined by the CRAs themselves and which may be easily engineered to replicate consultancy or advisory services. Finally, while sharing the Commission's concerns about possible interferences by the analysts in the design of the structured finance instruments to be rated (Article 9(5) of the draft proposal), the Eurosystem would like to point out that some interaction between the analysts and the sponsors/arrangers may be unavoidable and may not necessarily endanger the independence of the rating, providing the latter is only based on the intrinsic features of the financial instrument, which might have been effectively strengthened, from a credit risk perspective, in the course of the rating process.

Another measure that may be considered to lessen the conflict of interest that is inherent in the way the CRAs are paid, is to require that they collect a fee for the initial review of a financial instrument, regardless of whether the client eventually selects the CRA to rate that instrument. This kind of measure, similar to

those recently agreed⁹ in the United States, would reduce the incentives for "ratings shopping" and avoid the onerous disclosure obligations in relation to preliminary ratings described in the consultation paper, i.e. ratings initially sought by the client, but ultimately not issued or published (Annex II, Section C, part II.1 of the draft proposal). The fees charged for the initial review of structured finance instruments could also be reflected in the Transparency Report (Annex II, Section C, part III of the draft proposal). It is envisaged that this will provide financial information on the agency's revenue divided into fees from credit rating and non-credit rating services (Annex II, Section C, part III.6). A further breakdown of fees from credit rating services showing fees for the initial review might enhance the transparency of the fee-structure and discourage rating shopping.

2.3.2 QUALITY OF RATINGS

The Eurosystem agrees with the Commission that, in order to maintain confidence in the ratings issued by rating agencies, the achievement of a minimum level of quality and integrity in the rating process is key. In this regard, it is necessary that rating agencies ensure not only a minimum level of quality of initial ratings, but also a sufficient level of monitoring and updating of existing ratings.

The revised IOSCO Code already addresses most, if not all, of the concerns laid down in consultation document regarding the quality and integrity of the rating process. The Commission paper adds value in that it provides a framework for enforcing the principles contained in the revised IOSCO Code.

The limitations set out in Article 13 of the draft proposal on credit rating activity in situations where there is lack of sufficient and reliable data or the complexity of the structure is high are problematic from a practical point

⁹ Reference is made to the agreement reached by the Attorney General of the State of New York with the three principal rating agencies on 5 June 2008 (http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html).

of view. Whereas, on the one hand, the need to base ratings on robust and reliable data is indeed imperative, on the other, it is unclear what minimum level of information should be deemed sufficient to permit the issuance of a rating from a regulatory point of view. Therefore, in order not to stifle financial innovation, it would appear preferable to further assess how the lack of robust data or complexity of rated structured finance securities should be addressed. For example, a framework for an open dialogue between CRAs and competent authorities should be possibly set out.

2.3.3 DISCLOSURE REQUIREMENTS AND TRANSPARENCY OF CREDIT RATINGS

The Eurosystem broadly agrees with the disclosure obligations and the presentation of credit ratings contained in Article 14(1) and (2) of the draft proposal and the requirements set out in Annex II, section B. However, the requirement, contained in Article 14 (3) of the draft proposal, that rating categories attributed to structured finance instruments should be differentiated from rating categories to be used to rate other financial instruments may have substantial positive effects only if accompanied by enhanced education and communication by rating agencies as to the meaning of the different rating concepts and what they imply in terms of, for example, the differing levels of volatility in rating transitions and default prospects.

In addition, the Eurosystem strongly believes that pre-sale and post-sale performance reports, in particular, should be standardised as much as possible and frequently disclosed to the general public. In this regard, the Eurosystem has witnessed a deterioration in recent times in the disclosure standards of rating agencies for ABS. It is particularly important for the Eurosystem that the performance of asset-backed transactions is monitored on a regular basis. The Eurosystem also believes that the disclosure of the results of the rating assessment and of the regular surveillance reports can support the functioning of ABS markets by enhancing investor confidence. In this respect, the Eurosystem believes that CRAs

should publish rating reviews of asset backed securities at least on a quarterly basis. In the context of its monetary policy implementation, the Eurosystem will start to require that ABS, in order to be eligible as Eurosystem collateral, need to always have a rating pre-sale or new issue report, as well as quarterly rating performance reports.

Furthermore, the Eurosystem agrees on the need to increase the transparency of CRAs, not only in terms of their obligations in relation to the presentation and disclosure of ratings, but also in terms of minimum disclosure standards in relation to their organisational structure, internal governance and policies with an impact on the credit rating process. In this respect, Articles 15-17 of the draft proposal provide a broad and comprehensive framework which would enable the public, the compliance officers and the regulators to perform their respective monitoring duties. The set of information that must be made available to the public on an ad-hoc or periodic basis is particularly extensive. It is also important that this information is easily accessible and usable by the general public, including by non-professional investors.

The compliance function plays a crucial role both as a first line of defence against potential conflicts of interest and with respect to transparency. For these reasons, it is advisable to specify the minimum requirements for the compliance function in relation to its independence from other functions, including the internal audit, and in relation to its content, which should include the implementation and review of compliance policies and procedures across the whole organisation, as reflected in its annual report.

Finally, the Eurosystem notes that the draft proposal provides that CRAs shall make available in a depository open to the public all credit ratings and historical performance data (Article 15(2) of the draft proposal). The establishment of such a public depository is important for improving the availability of information on credit ratings, not only for

market participants, but also for statistical purposes, inter alia, because these contribute to market transparency. In particular, there is an increasing demand for statistical data on credit ratings. In the current draft proposal, no precise information on the proposed content of this depository is available. In particular, the Eurosystem would see merit in further clarification as to how the data on ratings will be presented and whether these data will fit into the EU statistical framework, i.e. the structuring and the storage of the data in a comparable format should conform with a standard to the extent possible (e.g. the use of the standardised ISIN code).

ANNEXES

I MONITORING ACTIVITY OF RATING AGENCIES PERFORMED BY THE ECB

The ECB, in its capacity as monetary policy authority, currently monitors the performance and activities of rating agencies. It performs this role in the context of the implementation of the monetary policy operations based on the Eurosystem Credit Assessment Framework for eligible collateral (ECAF). The ECAF is the set of rules and regulations that ensure that the collateral used by counterparties to back the lending obtained in monetary policy operations is of adequate credit quality. One of the ECAF's important tasks is to ensure that credit rating agencies that are eligible for ECAF purposes and that will be used as a source of credit assessment information of collateral, conform to some performance and operational standards as defined by the Eurosystem.

The performance monitoring framework conducted by the Eurosystem is applied consistently across the different eligible rating agencies and consists of the ex-post assessment of the ratings issued by the rating agency through a back-testing procedure. To carry out this task, the Eurosystem requires that all ECAF-eligible rating agencies provide static pool information at various times to the Eurosystem. The results of such analyses are shared with the rating agencies, and any possible deviation from the expected performance is discussed and any possible follow up to improve performance agreed with the rating agency. The current framework allows for the exclusion of a rating agency in severe circumstances of underperformance over a pre-specified period of time if the rating agency does not improve its rating output.

The ECAF ensures that the mapping of the different rating scales of the different rating agencies is correctly implemented. This requires a good understanding of the meaning

of the rating output of rating agencies, and background information that permits the correct construction of rating mapping tables is required from rating agencies on a regular basis.

2 CREDIT RATING AGENCIES IN THE EURO AREA

The Bank of International Settlements indicates that there are around 130 to 150 corporate rating agencies worldwide. Most of those agencies are small and typically focus on a particular jurisdiction or economic sector. Only a few are formally recognised by governments for regulatory purposes for which rating agencies need to receive the status of a Nationally Recognised Statistical Rating Organisation (NRSRO) in the United States by the Securities Exchange Commission or of Eligible Credit Assessment Institutions (ECAIs) in Europe by national supervisors. The European and global markets are dominated by three agencies that rate the debt of major corporations and nations: Standard & Poor's, Moody's and Fitch Ratings.

The table below provides a list of the currently approved ECAIs by supervisory authority in each of the euro area member states.

List of ECAIs approved by Supervisory Authorities of the euro area countries as of July 2008

	Moody's	S&P	Fitch	DBRS	Japan Credit Rating (JCR)	Banque de France	Coface	ICAP	Lince
BE	x	x	x		x	x			
DE	x	x	x	x	x				
GR	x	x	x					x	
IE	x	x	x	x	x				
ES	x	x	x	x					
FR	x	x	x	x	x	x	x		
IT	x	x	x						x
LU	x	x	x		x				
NL	x	x	x	x					
AT	x	x	x	x					
PT	x	x	x						
FI	x	x	x	x					
SI	x	x	x						
CY	x	x	x						
ML	x	x	x						

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