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COMMISSION STAFF WORKING PAPER

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the documents

Proposal for a Regulation

amending Regulation (EC) No 1060/2009 on credit rating agencies

and a

Proposal for a Directive

amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers

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INTRODUCTION

Regulation (EC) No 1060/2009 on credit rating agencies[1] (CRA Regulation) entered into full application on 7 December 2010. It sets out rules of conduct for credit rating agencies (CRAs). Furthermore, on 11 May 2011 an amendment to the CRA Regulation[2] was adopted, entrusting the European Securities and Markets Authority (ESMA)[3] with exclusive supervisory powers over CRAs registered in the EU in order to centralise and simplify their supervision at European level.

However, a number of issues related to credit rating activities and the use of ratings are not addressed in the existing CRA Regulation. Many responses to the consultation[4] carried out by the Commission and at the roundtable[5] organised by the Commission in June 2011 confirmed the need to address some remaining issues. These relate notably to the risk of overreliance on credit ratings by financial market participants, the high degree of concentration in the rating market and, to a certain extent, the way by which CRAs are remunerated.

Although there are a number of smaller CRAs, the rating market is dominated by three major CRAs (Fitch, Moody's and Standard & Poors), with a combined market share above 95 %

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1 Regulation of the European Parliament and of the Council on credit rating agencies of 16 September 2009, OJ L 302, 17.11.2009.

2 Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011.

3 Regulation (EU) No 1095/2010 of the European Parliament and of the Council established the European Supervisory Authority (European Securities and Markets Authority) (ESMA), OJ L 331, 15.12.2010, p. 84.

4 Public Consultation on Credit Rating Agencies launched by the European Commission services on 5 November 2010 and closed on 7 January 2011. More than 100 responses were received.

5 Roundtable on Credit Rating Agencies of 6 July 2011 organised by European Commission services.

globally.[6] Strong economies of scale in the sector as well as reputation of CRAs, which is a crucial asset, limit market entry. The specificities of certain categories of ratings, notably related to sovereign debt instruments, are not sufficiently addressed either. In particular, during the recent Euro debt crisis[7], CRAs were criticised with regard to the transparency and quality of the sovereign debt ratings and the question was raised whether the EU regulatory framework for CRAs needed to be further strengthened to address this. Finally, conflicts of interests linked to the shareholder structure of CRAs and civil liability of CRAs are also not sufficiently addressed in the current CRA Regulation.

PROBLEM DEFINITION

The problems described in the following section can be grouped into six broad areas:

- Overreliance on external credit ratings leading to "cliff" effects[8] in capital markets;
- "Cliff" and contagion effects of sovereign debt rating changes;
- Limited choice and competition in the credit rating market;
- Insufficient right of redress for users of ratings suffering losses due to an inaccurate rating issued by a CRA that infringes the CRA Regulation;
- Potentially undermined independence of CRAs due to conflicts of interest arising from the "issuer-pays" model, ownership structure and long tenure of the same CRA; and
- Insufficiently sound credit rating methodologies and processes

6 Finance – FAZ.NET, S & P, Moody’s and Fitch: Brussels’ battle against the rating oligopoly, June 2011. Available from: http://financesjournal.com/finances/moodys-fitch-brussels-battle-rating-oligopoly-5972.html.

7 A description and detailed analysis of the Euro debt crisis can be found in Annex VI of the Impact Assessment.

8 "Cliff effects" are sudden actions that are triggered by a rating downgrade under a specific threshold, where downgrading a single security can have a disproportionate cascading effect.

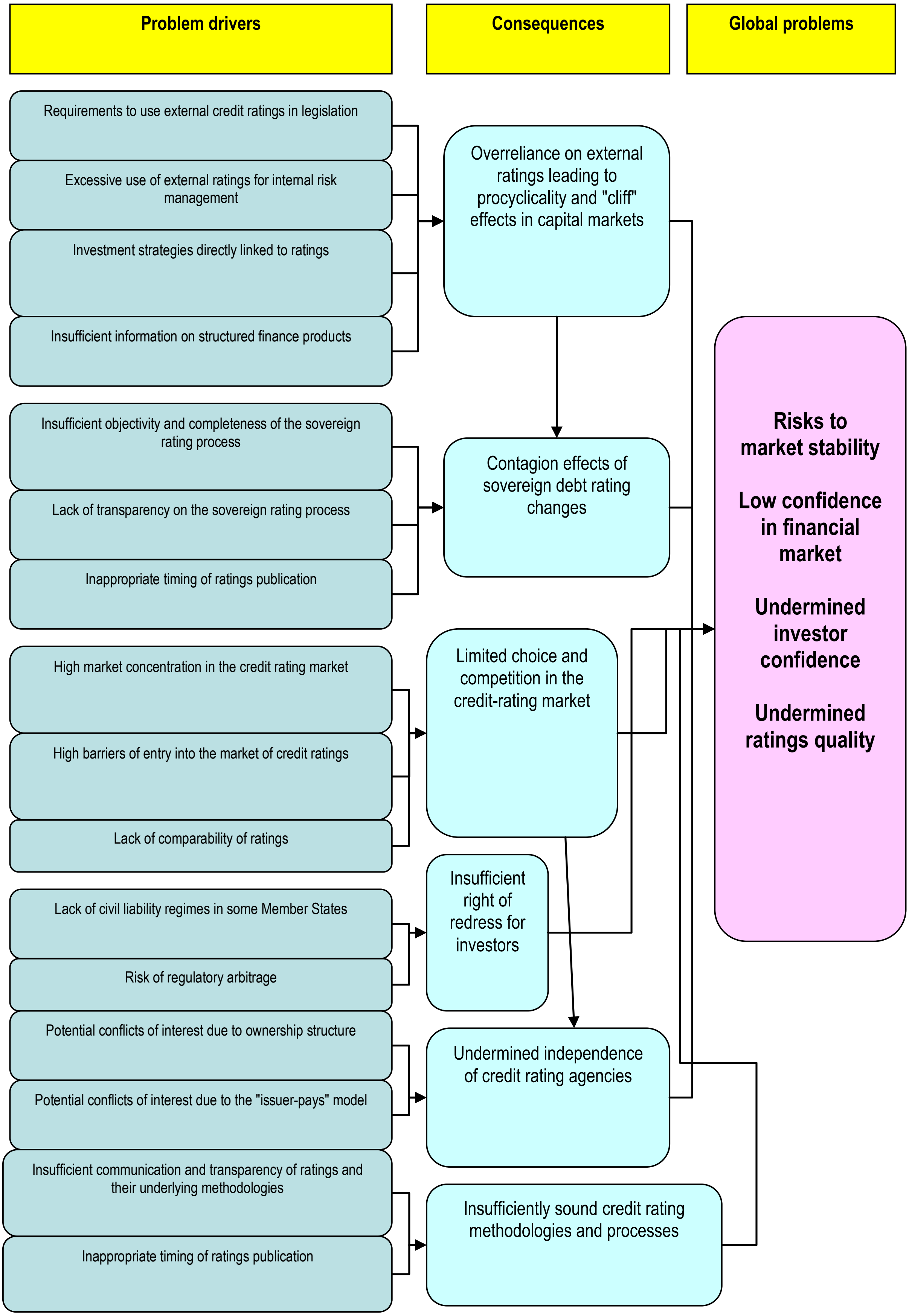

Figure 1. Problem tree

SUBSIDIARITY

According to the principle of subsidiarity (Article 5(3) of the TEU), EU level-action should be taken only when the aims envisaged cannot be achieved sufficiently by Member States alone and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the EU. Although all the problems outlined above have important implications for individual Member States, their overall impact can only be fully perceived in a cross-border context. This is because ratings can be issued in one country for financial instruments issued in another, so that action taken on a national level might not have any effect, as ratings could continue to be issued and used if they were produced in a different EU or even third country jurisdictions. As a result, national responses to credit rating issuance risk being circumvented or ineffective without EU-level action. Therefore any further actions in the field of CRAs can best be achieved by a common effort. Accordingly, EU action appears appropriate in light of the principle of subsidiarity.

OBJECTIVES AND PREFERRED POLICY OPTIONS

The general objective of the proposal is to contribute to reducing the risks to financial stability and restoring the confidence of investors and other market participants in financial markets and ratings quality. The set of policy options presented in this section aims at addressing the problems and reaching the corresponding specific objectives. The preferred options on the basis of their effectiveness and efficiency are highlighted in bold.

Policy options to diminish the impact of "cliff" effects[9] *on financial institutions and markets by reducing reliance on external ratings*

Policy Options
1. No policy change.
2. Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes.
3. Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating.
4. Improve disclosure requirements for issuers of structured finance products on an ongoing basis.

The Impact Assessment shows that measures to enhance internal credit risk management and the use of internal models for regulatory purposes and specifically improving disclosures by the issuers on structured finance products are the most cost-effective options in the current situation. Good quality ratings are helpful and should continue to be used; however it is important to incentivise the development of internal credit rating capabilities for firms with sufficient resources. Therefore, it should be ensured that a principle preventing over-reliance on credit ratings in line with the principles of the Financial Stability Board applies across the board to all actors in the financial markets. The first set of policy measures to limit reliance on credit ratings has already been included in the new Commission proposal for the modification of the Capital Requirements Directive (CRD IV).[10] Need for adaptation, at this stage, remains in particular in the areas of undertakings for collective investment in transferable securities (UCITS) and of Alternative Investment Funds (AIFs). Double ratings for structured finance products could allow a further reduction in reliance on ratings for these complex products.

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9 "Cliff effects" are sudden actions that are triggered by a rating downgrade under a specific threshold, where downgrading a single security can have a disproportionate cascading effect.

10 COM (2011) 453 final.

The preferred options are consistent with stakeholders' views that removing rules triggering mechanistic reliance on ratings from legislation is just one step and is not an immediate cure. Stakeholders also noted that it is a challenge to find suitable measures to replace the current use of external ratings. Using market measures instead of ratings was seen as inappropriately pro-cyclical and volatile by many, including industry groups and governments, but they could be taken into account alongside other measures. Some stakeholders, particularly issuers, opposed the idea of requiring multiple ratings as a measure to reduce overreliance, while some smaller CRAs welcomed a requirement for multiple ratings.

Policy options to mitigate the risks of contagion effects linked to sovereign debt ratings

Policy Options
1. No policy change.
2. Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff.
3. Require CRAs to publish sovereign ratings after the closure of EU trading venues.
4. Require CRAs to conduct the sovereign debt ratings process more frequently.
5. Extend powers of competent authorities (ESMA) to ensure rating methodologies comply with legal requirements.
6. Require (EU) sovereigns to publish a standardised set of data on economic performance to enable credit risk assessment.
7. Grant ESMA the power to restrict or ban issuance of sovereign debt ratings temporarily in exceptional situations.
8. Encourage an existing, independent EU structure or a brand new European Credit Rating Agency to issue credit ratings.
9. Prohibit sovereign debt ratings.

In the Impact Assessment, nine options were identified to mitigate the market stability risks resulting from sovereign ratings, out of which five options have been assessed as preferred ones. It is suggested that CRAs publish full research reports on sovereign ratings (option 2) – a measure which was also supported by some governments and industry stakeholders. The sovereign debt ratings process should also be conducted more frequently (option 4) and ESMA should have the necessary powers to ensure the compliance of methodologies with the requirements of the Regulation, but also to be in a position to ban issuance of sovereign ratings temporarily in well defined, exceptional circumstances (options 5 and 7), although some stakeholders opposed this idea. In the Impact Assessment, it is furthermore considered preferable that sovereign ratings are published after the closure of EU trading venues (option 3). The impact analysis concludes that for reasons of objectivity and credibility, as perceived by the market, it would not be appropriate to use an existing independent EU structure or to establish a brand new, public European Credit Rating Agency to issue sovereign credit ratings. Many stakeholders also raised concerns, in particular, with respect to the credibility of such ratings.

Policy options to improve credit rating market conditions with a view to improving ratings quality

Policy Options
1. No policy change.
2. Encourage the emergence of a network of small and medium-sized rating agencies.
3. Encourage the emergence of a new European rating agency.
4. Harmonise ratings scales to improve comparability of ratings between CRAs.
5. Establish a European Rating Index (EURIX).
6. Require CRAs to issue joint ratings at the level of the rating committee.

Policy Options
7. Ban large CRAs from acquiring small and medium-sized CRAs.
8. Introduce temporary market share ceilings for CRAs.
9. Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and are based on costs.

The Impact Assessment analyses a wide range of options to improve credit rating market conditions that should be conducive to ensuring independence of CRAs and high quality ratings. Improved transparency (options 5 and 9) and comparability of ratings (option 4) are considered to be cost-effective options. Moreover, fostering the creation of a network of small and medium-sized rating agencies is seen as a preferred option to reduce the barriers to entry into the market. The creation of a European rating agency as a public, rather than private, initiative has not been assessed as a preferred option. A vast majority of stakeholders were also against this measure. The ban for large CRAs from acquiring small and medium-sized CRAs would be necessary to ensure effectiveness of other preferred options, including those addressing issues on CRAs' independence. However, this ban on its own would not be effective to change the market structure and could be circumvented by CRAs.

Policy options to ensure right of redress for investors

Policy Options
1. No policy change.
2. Introduce civil liability of CRAs into EU legislation.
3. Ensure civil liability of CRAs towards users of credit ratings before national courts.

To ensure the right of redress for investors, the Impact Assessment recommends option 3 which would introduce a general obligation to ensure civil liability of CRAs before national courts. There is a general view from the stakeholders (with the notable exception of the CRAs themselves) that it should be possible to pursue civil action against rating agencies but only for gross negligence or intent.

Policy options to improve ratings quality by reinforcing independence of CRAs and promoting sound credit rating processes and methodologies

Policy Options
1. No policy change.
2. Require investors to pay for ratings ("investor-pays" model).
3. Require trading venues to set up and ensure the administration of the "Trading venues pay" model.
4. Require CRA selection to be undertaken by an independent board.
5. Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself.
6. Introduce specific requirements on CRAs' independence and objectivity in relation to their shareholders
7. Strengthen rules on disclosure of rating methodologies
8. Require CRAs to inform issuers sufficiently in advance of the publication of a rating

The Impact Assessment identifies eight options to reinforce independence of CRAs. Other models that could be alternatives to the "issuer pays" model are not entirely free from potential conflicts of interest. In this regard, the Commission will continue to monitor the appropriateness of credit rating agencies' remuneration models and will submit a report thereon to the European Parliament and the Council by 7 December 2012, as required by Article 39 (1) of the CRA Regulation. The preferred options in the Impact Assessment encompass the measures to further mitigate independence risks under the "issuer pays" model. Indeed, many stakeholders believed that the risks under the "issuer pays" model are manageable. To this end, the Impact Assessment recommends mandatory rotation of CRAs (option 5), including the requirement to have different CRAs to rate an issuer and its products (not applicable in respect to sovereigns), and rules to deal with ownership interests (option 6). Moreover, rules on transparency and publication of ratings are assessed to be preferred options (options 7 and 8) to further address conflicts of interest and contribute to high quality ratings. However, the effectiveness of these measures, in particular mandatory rotation of CRAs, can only be ensured if the market conditions are conducive to the growth of small CRAs and the entrance of new players in the rating market.

OVERALL IMPACT OF THE PACKAGE

Cumulative Impacts and Synergies

This section presents the cumulative impacts from the implementation of the package of preferred policy options. The package of preferred policy options has been developed in a way to ensure the achievement of the overall objective to "*contribute to reducing the risks to financial stability and restoring investor and other market participants' confidence in financial markets and ratings quality*".

The preferred options are expected to reduce overreliance on external ratings by reducing the importance of external ratings in financial services legislation. This is expected to reduce reliance on external ratings by credit institutions, insurance undertakings, investment funds and the asset management sector. In addition, the preferred policy measure to introduce a requirement for issuers to improve disclosure regarding the underlying asset pools of structured finance products is expected to help investors to make their own credit risk assessment, rather than leaving them to rely solely on external ratings.

Furthermore, the preferred options will improve the transparency and quality of sovereign debt ratings through verification of underlying information with a sovereign. A first measure will require CRAs to verify the accuracy of information with sovereigns to ensure that potential errors of sovereign ratings are avoided. Moreover, the transparency and quality of sovereign ratings would be enhanced through the publication of the full research report accompanying the rating. The publication of sovereign ratings after the closure of European trading venues aims at enabling all market participants to have the new rating information before the trading venues are opened and it would thus contribute to limiting major market disturbances. Additionally, to mitigate the risk of contagion effects of sovereign downgrades ESMA, in specific situations determined by the regulation, would be granted the power to ban sovereign ratings temporarily. This measure should be temporary, exceptional and subject to very strict conditions.

The preferred policy measures are also expected to improve choice and optimise the structure of the rating industry. Small and medium-sized rating agencies would be encouraged to exchange information which could facilitate new market entrants entering the rating industry and offer a wide range of services. In addition, comparison of ratings from distinct rating agencies could be facilitated by promoting common standards for rating scales and a European Rating Index (EURIX). Furthermore, improved transparency on pricing policies and fees would not only facilitate competition in the rating market, but would also enable ESMA to effectively monitor potential conflicts of interest resulting from the "issuer pays" model. Finally, mandatory rotation of CRAs would not only substantially reduce the familiarity threat to CRA independence resulting from a long business relationship between a CRA and an issuer, but would also have a significant positive effect on improving choice in the rating industry by providing more business opportunities for smaller CRAs.

In terms of investor protection, the preferred options would ensure that investors have an appropriate right of redress against CRAs. This would also provide strong incentives for CRAs to comply with legal obligations and to ensure high quality ratings.

Independence of ratings will be improved by introducing a requirement for issuers to change CRA periodically. Risks of conflicts of interest would be further reduced by the requirement that a CRA should not be able to provide solicited ratings for an issuer and its products simultaneously. Furthermore, independence will be improved by enhancing the ownership structure of CRAs. In addition, transparency and quality of ratings would be improved by strengthening the rules on the disclosure of rating methodologies, by introducing a process for the development and approval of rating methodologies, including the requirement for CRAs to communicate and justify the reasons for modifications to their rating methodologies. Finally, the quality of ratings would be enhanced by requiring CRAs to inform issuers sufficiently in advance of the publication of a rating.

Assessment of Administrative Burden and Compliance Costs

There would be additional costs for financial firms resulting from the requirements to enhance internal risk management and the use of internal rating models for regulatory purposes. These costs would be substantial for relevant financial sectors as a whole, but proportional with respect to individual financial firms. There would also be additional costs to issuers due to enhanced disclosure requirements, the total of which could amount to EUR 1.7 million one-off cost and EUR 1.92 million annually.

A set of options to mitigate risks of contagion effects linked to sovereign ratings, would also lead to additional recurring compliance costs to CRAs, which could amount to EUR 3.27 million annually to the industry.

Measures to improve competition would not significantly increase the costs for CRAs (the annual compliance cost for the rating industry is expected to be around EUR 1.38 million). The costs would only relate to promoting the emergence of a network of small and medium-sized CRAs that could range annually between EUR 0.9 and 1.95 million, for which the Commission would explore possibilities for EU funding.

The policy option related to civil liability of CRAs towards investors is expected to cause compliance costs due to the need to insure their civil liability or, in the absence of the insurability, to create a financial buffer to cover potential claims from investors.

Finally, the preferred options dealing with CRA independence are not expected to entail any significant costs.

Choice of Legal Instrument

The current initiative encompasses a wide range of measures. They can be divided in four categories:

- measures requiring amendments to the current CRA Regulation;

- measures requiring amendments to the current CRA Regulation coupled by technical standards to be developed by ESMA;
- measures requiring amendments to sectoral legislation (Directives on UCITS and managers of AIFs);
- measures building on an existing Union funding program in order to promote a network of small and medium sized CRAs.

MONITORING AND EVALUATION

If the recommended policy options are put into practice, the Commission will monitor how Member States apply the proposed policies. When necessary, the Commission will pursue the procedure set out in Article 226 of the Treaty in case any Member State fails to respect its duties concerning the implementation and application of Union Law.

In order to assess the effectiveness of the proposed policies, the Commission will propose to set up a range of indicators to feed into a monitoring system to facilitate an evaluation three years after the transposition date (possibly in the form of a report to the Council and the Parliament).

As part of the monitoring exercise, ESMA would receive quarterly reports from national competent authorities on the various policy areas.