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## CREDIT RATING AGENCIES

### Executive Summary

- BUSINESSEUROPE supports restoring investor confidence in credit rating agencies and the ratings they produce through a robust and efficient regulatory framework.
- Regulation should not disrupt the use of ratings which are an intrinsic part of global finance.
- Regulation should be proportionate, globally consistent and non-protectionist.
- Regulation must be limited solely to the use of credit ratings for regulatory purposes by financial institutions.
- Regulation should take account of the specific structure of credit rating agencies, which is a very concentrated and oligopolistic market. Consequently, special attention should be given to the effects of regulation on the opening of the market to potential new players on the market.
- Ratings should never be accepted as a substitute for comprehensive internal risk assessment and forms only one part of the due diligence undertaken by investors.
- Any registration process for credit rating agencies should take account of the need for those responsible for registration decisions to liaise with, and make consistent decisions with, each other, with supervisors responsible for recognising CRAs under existing EU law, and with third country authorities.
- All European authorities responsible for approvals of the use of and supervision of credit rating agencies should cooperate with each other and with third country authorities in a collegiate way with a view to reaching consistent decisions in Europe and worldwide.



## INTRODUCTION

The Commission proposal for a Regulation addresses the problem of transparency and protection of investors, management of conflicts of interest, quality of ratings and rating methods. BUSINESSEUROPE believes that it would be advisable to place the European regulation on credit rating agencies (CRAs) within the framework of prudential rules governing financial markets and also within the context of developing global regulation of CRAs, based on the IOSCO principles.

It is also important that a European regulation takes into account the specific structure of credit rating agencies, which is a very concentrated and oligopolistic market. Consequently, BUSINESSEUROPE recommends that special attention be given to the effects of the European regulation on the opening of the market to potential new players on the credit rating agencies market.

BUSINESSEUROPE would also like to stress that ratings should never be accepted as a substitute for comprehensive internal risk assessment and forms only one part of the due diligence undertaken by institutional investors. Regulation may be perceived as enhancing the importance of CRAs and therefore increase the tendency of investors to rely on them. Consequently, the scope of the Regulation should be narrow and only applicable for ratings used in connection with compliance with EU legislation.

BUSINESSEUROPE would like to suggest some key amendments to the detail of the proposal that are necessary to eliminate likely harmful impacts of certain provisions for European Investors and Issuers. These comments and suggestions for change are set out below.

## THE PROPOSED REGULATION

### ➤ Registration and supervision of credit rating agencies

The proposal for a regulation provides for procedures for the registration and supervision of credit rating agencies at the European level (title III of the regulation 2008/0217).

- **A fragmented registration and supervision process and a source of inefficiency, confusion, contradiction, uncertainty and damage to markets**

The registration process for credit rating agencies at European level presented in the draft regulation does not take into account the need for those responsible for registration decisions to liaise with, and make consistent decisions: with each other; with supervisors, in particular prudential supervisors, responsible for recognising CRAs under existing EU law; and with third country authorities.



The lack of co-ordination of approval and supervision procedures would be a source of considerable extra cost that would harm the stated goal of efficiency of the European regulation.

- **A collegiate structure at European and global level; strong coordination with international regulatory authorities, especially with the US SEC, and the necessary convergence**

BUSINESSEUROPE requests that the Regulation provides that all European authorities responsible for approvals of the use of and supervision of credit rating agencies be expected to cooperate, with each other, and with third country authorities, in a collegiate way, with a view to reaching consistent decisions Europe and worldwide.

➤ Purpose and scope (article 2)

- **Purpose**

BUSINESSEUROPE fully approves the goals specified in the European proposal for a regulation to restore and maintain confidence in ratings. It achieves this goal by developing requirements in relation to: managing conflicts of interest, requiring controls to check the quality of rating methods and ratings issued and guaranteeing independence and transparency.

It should be pointed out in this regard that some rules and procedures relating to said goals have already been set out under the IOSCO Code of Conduct and thus constitute a framework in this field with which EU requirements should aim to be consistent.

- **Scope**

The application of this draft regulation must be limited solely to the use of credit ratings for regulatory purposes by financial institutions:

The scope of the Regulation needs to be clear and objective so that CRAs and firms know what they need to comply with. The Commission proposal suggests regulatory purposes and other purposes, and the need for MIFID firms to execute orders only on transactions where the rating comes from a registered CRA. In BUSINESSEUROPE's view, this renders the scope uncertain.

For example, if the scope is related to "any use" of ratings, then, because ratings are publicly available and the CRA has no control over how they are used, it is impossible to know whether they would need to be registered or not (this is particularly relevant for overseas rating agencies who operate in local markets but where the paper is bought by a European).

Another alternative would be to require registration for those CRAs that operate in some form in Europe as per article 4(1). This also has problems because the big



players operate on a global basis and the legal entity does not define the rating process. Forcing the rating to be done out of the EU will lead to duplication and loss of quality as local expertise would be lost. Additionally, if registration is significantly different in the EU from elsewhere this would undermine the objective of competition. This also sets a precedent for the future of capital market regulation stimulating fragmentation.

The final option, which the Council is pursuing, is to go for use solely for regulatory purposes. This is the only option that would be enforceable, given that at least it is objective. However even this is not without problems as third country rating agencies still need to be addressed in some way. If this is not the case, then this will cause problems for firms if they are suddenly not able to use third country ratings, with, for example, implications for capital requirements which could lead to forced sales of assets, which would not be desirable in the current fragile market. It would also restrict the ability to invest outside Europe going forward possibly leading to retaliatory measures from third countries and compromise European CRA's ability to compete for global business.

Therefore BUSINESSEUROPE would recommend that the scope be restricted to regulatory purposes only. The definition of Regulatory purposes should be set out in an Annex so that it could be updated as necessary. Specific provisions should be put in place to provide for the recognition of third country rating agencies through a system of recognition of broad equivalence of outcomes. Time will be needed to agree such equivalence. An intermediate system of endorsement for global agencies with a presence in Europe goes some way towards addressing the issue, but does not fully solve it.

Furthermore, we support the removal of Article 4 (2) as this has a big impact on the ability of firms to invest in non-EU products.

➤ Issue of ratings

○ **Independence and prevention of conflicts of interest (article 5)**

BUSINESSEUROPE supports the initiative taken by the European Commission to implement measures with a view to ensure that ratings are independent. Consequently, authorities should not be able to interfere either in individual ratings or the methodologies that credit rating agencies use. The draft regulation highlights the operational and organisational requirements (Annex I –sections A and B of the European regulation) with which the credit rating agencies have to comply. In particular, the separation of credit rating and of advisory activities for one and the same instrument is an essential measure for the management of conflicts of interest.

However, whilst agreeing with the good governance objective and the spirit of the proposals, BUSINESSEUROPE has concerns whether the statutory governance requirements for credit rating agencies may conflict with domestic laws in Member States. For example, how would the interaction between the independent 'members' of the administrative/supervisory boards and the non-executive directors in listed



agencies be envisaged? Prescribing a wholly separate set of statutory governance requirements for credit rating agencies would also set a precedent for other sectors.

#### Comments on annex B (paragraph 3) and Annex D (paragraph 3)

The proposed Regulation requires the withdrawal of ratings, or registration, or the suspension of ratings, in a range of circumstances. For users of ratings this is a major concern. Time is needed to find a replacement or to enable firms to change systems if a rating becomes no longer valid for regulatory use. The consequences of instant withdrawal of ratings would be very significant. Therefore; there should be the opportunity of re-rating in those instances where the Proposal suggests withdrawal and a transitional provision if the credit rating agency's registration is suspended. In the short-term, qualifications of ratings should be dealt with by a public statement that the rating is potentially compromised.

#### Comments on annex B (paragraph 5)

As a whole, these requirements are satisfactory and BUSINESSEUROPE especially notes the requirements set forth in section B- paragraph 5: "A credit rating agency shall ensure that analysts do not make proposals or recommendations, either formally or informally, regarding the design of structured finance instruments on which credit rating agency is expected to issue a credit rating". This provision should be applied in a way which enables CRAs to continue to be able to advise issuers, at their request, on what would be the rating implications of different possible product structures.

#### Advisory services

Argument 7 of the proposal for a regulation provides: "In order to avoid potential conflicts of interest credit rating agencies should limit their activity to the issuing of credit ratings. A credit rating agency should not be allowed to carry out consultancy or advisory services, as is set out in the IOSCO code of conduct. In particular credit rating agency should not make proposals or recommendations regarding the design of a structured finance instrument. However, credit rating agencies should be able to provide ancillary services where this does not create potential conflicts of interest with the issuance of credit ratings".

The wording "ancillary services" of the proposal for a regulation is vague, so BUSINESSEUROPE would like the regulation to clearly specify that the "ratings assessment services" are part of the ancillary services of which a list shall be drawn up and which may thus be authorised.

Regarding "shadow rating" requests, BUSINESSEUROPE is worried that this will encourage 'ratings shopping' which should be avoided.

In addition, it is important to stress the interest of a supervision of rating agencies at the European level but also to specify that it must not result in limiting the possibilities and



prerogatives of issuers. The supervision of the practices of credit rating agencies must not lead to restrictions that would burden issuers using credit rating agencies insofar as these activities are carried out in compliance with rules and goals defined in the draft regulation.

- **Employee (article 6)**

Paragraph 4: “A credit rating agency shall ensure that analysts and persons approving credit ratings shall not be involved in providing the credit rating services to the same rated entity or its related third parties for a period exceeding four years. For that purpose, it shall establish a rotation mechanism with regard to those analysts and persons.”

The rotation mechanism proposed in the draft regulation provides for a rotation of analysts and persons responsible for approving credit ratings every four years. BUSINESSEUROPE proposes that this rotation mechanism should take account of the time it takes to build up knowledge and expertise on companies and sectors rated, and should apply only to senior analysts and not to review boards, whose members have no contact with the rated entity.

- **Methods and quality of ratings**

Quality of information used and ratings issued: possibility of auditing the accounts of the rated companies (argument 38 and article 7.2)

The relevant provisions of the draft regulation refer to the goal of protecting investors (argument 38: “Since the objectives of the action to be taken, namely to ensure a high level of consumer and investor protection by laying down a common framework with regard to the quality of credit ratings...”).

BUSINESSEUROPE understands that the European Commission’s goal of restoring investor confidence is essential to the working of the financial markets but it is necessary however to stress that the role of credit rating agencies on financial markets consists of informing the market and not of protecting investors. It is a matter of providing them with the most relevant and complete information by using the means necessary for this purpose in order to achieve the stated goal of protecting investors and providing them with a framework in which they take their investment decisions based on quality information.

At the same time, investors must assume responsibility for their investment decisions. They must be based not only on the credit ratings issued, but also and equally on their own analyses and assessments of risks associated with their investments and on those of financial analyst companies.

To ensure the quality of credit ratings issued, the draft regulation provides for a certain number of requirements to be met by credit rating agencies but also the prerogative “...



verification by reputable third party services... of financial statements and other information available on rated companies” (Argument 15).

The idea of verification is set out in article 7.2, it states that “a credit rating agency should take measures to ensure that the information it use in assigning a rating is reliable (...). For this purpose, a credit rating agency may envisage, among other elements reliance on independently audited financial statements and public disclosures; verification by reputable third party services...”

BUSINESSEUROPE does not support this provision of the draft regulation which aims to increase the responsibility of credit rating agencies not only with regard to the quality of their own analyses but also on information provided by issuers. It should be recalled that this information was approved under the joint responsibility of issuers and, in some instances, their statutory auditors. It is important that CRAs would not have to validate the information themselves. CRAs should not be responsible for the data quality but should ensure that there is appropriate due diligence performed on the information.

In addition, BUSINESSEUROPE requests that such a right of investigation of the accounts of rated companies, which have already been audited by a statutory auditor, be withdrawn.

#### Quality of rating methods: monitoring of statistical performance

The quality of rating methods and ratings is one of the central goals of the draft regulation. BUSINESSEUROPE recommends that an obligation to publish statistical performances be introduced (default rate and transition models). It would involve providing an annual report on differentiated statistical performances depending on the products rated: “corporate” products and structured finance instruments.

The record of statistical performances would be a relevant piece of information in light of the problems related to the quality of rating methods and ratings, in particular, regarding structured finance products bearing in mind of course that ratings are still only opinions on the future.

- **Publication and presentation of credit ratings (article 8 and annex section e)**

#### Article 8: Obligations regarding structured financial instruments

BUSINESSEUROPE supports the initiative of the European Commission regarding structured finance instruments. Indeed, in light of the financial crisis and the role of structured finance instruments, it appears important to reinforce measures to supervise the rating activity associated with these products and instruments.

BUSINESSEUROPE is in favour of the provisions of article 8.3 which presents the disclosure obligations that credit rating agencies must meet in this field: a clear





provision of information on the factors that will affect the rating of these products and their volatility is essential.

#### Annex section E: Periodic publications

The draft regulation provides for an obligation to publish the list of the 20 largest clients of each credit rating agency each year. BUSINESSEUROPE thinks that the requirements on this point should align with IOSCO guidelines.

BUSINESSEUROPE would suggest though that ratings are stored for a given period (i.e. 10 years) on the CRAs as well as the supervisor's website to establish the quality of rating methods and models for each product or activity for which the agency was approved.

- **Economic model of credit rating agencies (article 11 and article 34)**

The draft regulation provides that “the Commission shall assess ... the appropriateness of the remuneration of the credit rating agency by the rated entity (issuer-pays model)” (article 34). Moreover, article 11 provides that “a credit rating agency may not charge a fee for the information provided ...”. Thus, the proposal for a European regulation on credit rating agencies sets aside any change in the economic model of credit rating agencies at first but seems to indicate that it will be given thought in the scope of the assessment report that the Commission makes on the degree of application of the provisions of the European regulation (three years after its entry into force).

From BUSINESSEUROPE's point of view, there are potential conflicts of interest issues with all the business models for ratings activity (whether issuer pays, subscriber pays, public body pays, etc.).

This is an important issue to which BUSINESSEUROPE calls the European Commission's attention: a thorough reflection on this subject must be first initiated with all relevant parties. Accordingly, no final decision should be taken on the economic model of credit rating agencies in the scope of the European regulation.

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