BRIEFING

Scrutiny papers

European Parliament

Level-2 measures and reports under the Credit Rating Agencies Regulation

Committee on Economic and Monetary Affairs

Scrutiny Session of 3 May 2017

This briefing has been drawn up to support **ECON's work on the scrutiny** of delegated acts, in particular as regards the discussion of **3 May 2017** on the implementing measures under Regulation (EC) No 1060/2009 on credit rating agencies (CRAs)[1].

In brief

On 7 December 2010, Regulation (EC) No 1060/2009 on credit rating agencies (**CRA I**) entered into force and introduced mandatory registration and supervision for all CRAs operating in the European Union (EU). It was amended four times, most significantly by Regulation (EU) No 462/2013 (**CRA III**), which came into force on 20 June 2013 with a view to addressing the CRA market's shortcomings and problems with the publication and the use of ratings, in particular sovereign ratings. All level-2 measures required under the CRA Regulation have now been adopted and are applicable. After the European Securities and Markets Authority (ESMA) issued its technical advice in 2015, the Commission adopted on 19 October 2016 a general report to fulfil its various reporting mandates under the CRA Regulation. This briefing describes the various issues addressed by the existing level-2 measures and reports, as well as recent developments concerning the implementation of the CRA Regulation.

THE CRA REGULATION AND ITS IMPLEMENTING MEASURES

CRAs issue opinions on the creditworthiness of entities or debt instruments, and their ratings have a large impact on financial markets. Given that the financial crisis had exposed shortcomings in CRAs' self-regulatory systems, the CRA I Regulation imposed strict requirements for CRAs. The Regulation was first amended in 2011 by Regulation (EU) No 513/2011 (**CRA II)** to reflect the creation of ESMA, empowering it to register and directly supervise CRAs in the EU. A further amendment by CRA III included new provisions on CRAs' conflicts of interests and governance, as well as measures aimed at fostering competition on the CRA market, reducing over-reliance on ratings and addressing problems related to sovereign ratings which had been identified at the time of the euro sovereign debt crisis.

All level-2 measures required by the CRA Regulation are now applicable. The level-2 measures consist of two delegated acts, 10 implementing acts and seven regulatory technical standards (RTS). In early 2015, the three RTS set out in CRA III entered into force. The last measure to become applicable was the RTS on the disclosure of structured finance instruments, on 1 January 2017.

[1] 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) as amended by Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 (OJ L 145, 31.5.2011), by Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 (OJ L 174, 1.7.2011), by Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 (OJ L 146, 31.5.2013), and by Directive 2014/51/EU of the European Parliament and of the Council of 18 April 2014 (OJ L 153, 22.5.2014).

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Responding to its reporting obligations set out in the CRA Regulation (*Art. 39 and 39a*), the Commission published a report on 19 October 2016 in which it assessed **the effects of certain key provisions introduced by the CRA Regulation**. The review concluded that no further legislative action was recommended at that stage, as the Commission believed that the effects of the Regulation still needed time to unfold.

While **CRA III and its implementing measures** achieved certain improvements in the objectiveness of credit ratings and rating outlooks, as well as their quality, the Commission (having received technical advice (TA) from ESMA and two external studies to bolster its views) recognised in its report of October 2016 that **a number of particularly difficult issues remained a cause for concern**.

This briefing describes recent level-2 developments related to the most prominent issues:

- **issues at the level of the CRA market**, such as a persistent low level of competition due to insufficient business for new market entrants and smaller CRAs, and remaining conflicts of interest;
- **issues at the level of the external ratings by CRAs**, such as their transparency and quality including the latest developments on provisions on general and periodic disclosures, on the European Rating Platform and on disclosure requirements for SFIs;
- **issues at the level of the use of external ratings by financial institutions**, in particular their over-reliance thereon due to difficulties in finding alternatives and references to their use in EU financial services legislation .

EFFECTS OF THE CRA REGULATION ON COMPETITION AND MARKET BEHAVIOUR

The main contributions of CRA III in this respect were the **mandatory double rating for structured finance instruments** (SFIs, i.e. securitisations) (*Art. 8c*) and the requirement for issuers to apply the '*comply or explain*' principle to a recommendation to **consider at least one small CRA in the case of double rating** (*Art. 8d*).

Yet ESMA reported in its annual market share calculation of December 2016 that the European credit rating market share of the **three biggest players on the CRA market** (Standard & Poor's Group, Moody's Group and Fitch Group) still stood at almost 93 % in 2015. This persisting dominant share of the three biggest players contrasts with the fact that the market is made up of almost 30 CRAs – 25 registered and four certified, according to the list of CRAs published by ESMA (pursuant to *Art. 18(3)*).

In its TA of 30 September 2015 on competition, choice and conflicts of interest in the credit rating industry, ESMA considered that more time was needed to fully assess the impact of the measures introduced by the CRA Regulation on competition in the market. The same conclusion was reached in the Commission's 2016 report, which states that these smaller CRAs and new market entrants do not yet have sufficient business across all asset classes and that the level of competition remains low. On the subject of small CRAs, in a communication of November 2016 on the EU regulatory framework for financial services, the Commission announces its plans to assess the possibility of a more proportionate application of the CRA Regulation to small CRAs.

To facilitate the successful implementation of the provisions concerning the use of smaller CRAs (*Art. 8d*), ESMA issued on 6 April 2017 a supervisory briefing, addressed to the sectoral competent authorities (SCAs) empowered to ensure the compliance of issuers and related third parties. ESMA proposed a common supervisory approach for SCAs and a standard documenting format for issuers and third parties. Comparing compliance among issuers and related third parties will also be easier for supervisors and any market participants.

The 2016 Commission report also analyses the effects of the measures laid down in the CRA Regulation to address **CRAs' governance shortcomings and conflicts of interests** (*i.e. Art. 6, 7, 8*), including the use of alternative remuneration models. The Commission considers the provisions effective overall in giving regulators the necessary tools to supervise non-compliant CRAs. Moreover, the Commission believes that

ESMA's guidelines on the validation and review of CRAs' methodologies (*see below*) will provide further clarity on the internal compliance and risk procedures of a CRA.

EFFECTS OF THE CRA REGULATION ON IMPROVING QUALITY AND TRANSPARENCY OF RATINGS

The CRA Regulation introduced measures aimed at increasing public disclosures of ratings, of data on underlying assets and of statistics on ratings. The measures were intended to help improve the quality and independence of ratings and, by increasing their comparability, foster competition between CRAs. The latest developments in these areas are as follows:

- The provisions on **general and periodic disclosures** of information by CRAs (*Art. 11(2))* include the obligation to report statistics on CRAs' rating activities and performance and to ESMA's Central Repository (the CEREP database). The Commission concluded that, while **publishing data** can increase the visibility of smaller CRAs, it is still more likely to benefit sophisticated investors that compare data between CRAs more easily.
- In addition, the CRA Regulation introduced the **European Rating Platform** (*Art. 11a*), which provides granular information on specific rated entities and instruments that complement the CEREP. This platform, which falls within the remit of ESMA, has been operational since 1 December 2016 and should, over time, increase the visibility of smaller CRAs and facilitate rating market transparency.
- Issuers of **SFIs** must disclose detailed information on the securitisation and its underlying exposures (*Art. 8b(1)*). The content of the information to be disclosed was further specified in the RTS on disclosure requirements for SFIs (Commission Delegated Regulation (EC) No 2015/3). ESMA is also mandated *(Art. 8b(4))* to set up a website for the publication of such information. However, in the absence of a legal basis to fund this website, ESMA has been unable to meet its legal obligation to do so before 1 January 2017, as publicly announced in 2016. Nevertheless, the proposed regulation on a framework for simple, transparent and standardised securitisation, currently the subject of trilogue negotiations, is expected to provide a more effective way of ensuring disclosure of information on underlying exposures in SFIs by their issuers.

Another major concern is the significant effects on markets of unannounced publications of revised sovereign debt ratings; their revision causes sudden market tensions and regulatory cliff effects for holders of such bonds. The CRA Regulation (*Art. 8a*) requires CRAs to publish annual calendars containing the publication dates of their sovereign credit ratings, so as to anticipate potential rating changes. In addition, the Commission was mandated to assess the appropriateness of developing a **European creditworthiness assessment** for sovereign debt and a European public CRA for that purpose. In a report of 23 October 2015, the Commission analysed the potential of investors in the EU bonds markets conducting their own credit risk assessments. This 2015 report and the general report of 2016 conclude that such a European creditworthiness assessment would add little additional information to data already available in the fiscal and macro-economic surveillance regime (e.g. the European Semester). Institutional investors not only already have access to these sources but also prefer other sources, such as the IMF. Though the idea of establishing a European CRA remains the subject of public debate, the Commission further dismissed any plans therefor by concluding in its 2016 report that there is currently no need for such an agency for sovereign debt, or for a European credit rating foundation for other credit ratings.

As to the quality of ratings by CRAs, ESMA adopted in November 2016 (pursuant to *Art. 8(3)*, after entry into force of the RTS on rating methodologies (Commission Delegated Regulation (EU) No 447/2012), its final guidelines on the validation and review of CRAs' methodologies, which are to enter into force on 23 May 2017. To harmonise the quality of ratings across the European Union and across CRAs, and thereby protect investors, the terminology used in the RTS on rating methodologies, such as 'discriminatory power', 'historical robustness' and 'predictive power' (*Art. 7*) are clarified, and guidance is provided on how CRAs should meet other requirements of the RTS (*Art. 8)*. The guidelines follow a 2015 special report by the European Court of Auditors (ECA) on the EU supervision of CRAs which drew attention to the fact that the CRA regulation does not provide any definitions or criteria for regulatory requirements for the rating

methodologies of CRAs. While covered in part by the RTS on rating methodologies, the ECA considered that some of the terms used in the RTS would benefit from further clarification to the benefit of supervisors and CRAs. The guidelines should overall lead to higher quality in the methodologies used by CRAs (e.g. stronger discriminatory and predictive powers and historical robustness).

Finally, in respect of **ratings issued by a third-country CRA**, ESMA published on 4 April 2017 a consultation paper on the update of the guidelines on the application of the endorsement regime under Art. 4(3) of the CRA Regulation. 'Endorsement' allows credit ratings issued by a third-country CRA that are endorsed by an EU CRA to be used for regulatory purposes in the EU. The draft updated guidelines would place the onus on the endorsing CRAs to verify and be able to demonstrate that the third-country CRA has effectively established internal requirements that are as stringent as those required under the CRA Regulation, and that it fulfils its own internal requirements in practice and on an ongoing basis.

REDUCING OVER-RELIANCE ON EXTERNAL CREDIT RATINGS

While the CRA Regulation has established a wide array of measures, the use of external ratings by financial institutions remains naturally engraved in sectoral legislation. ESMA's TA of 30 September 2015 on reducing sole and mechanistic reliance on external credit ratings explained that smaller issuers in particular may find it difficult to find alternatives to the external credit ratings, on account of a lack of resources and expertise, and that the focus should rather be on the mitigation of mechanistic reliance on the ratings. The 2016 Commission report also drew attention to the fact that EU financial services legislation still contains **references to the use of external credit ratings** and could in itself trigger over-reliance. In particular, CRR (Regulation (EU) No 575/2013) and Solvency II (Directive 2009/138/EC) call for the use of ratings in critical areas such as the calculations of regulatory capital or solvency requirements. The Commission also concluded that there are currently no appropriate alternatives to replace external CRAs.

Recent efforts have therefore focused on limiting the contractual over-reliance on external credit ratings by issuers and the mechanistic effects of such an over-reliance. Under sectoral legislation such as the CRR or Solvency II, the European Supervisory Authorities (ESAs) are mandated to assess overreliance on ratings by both regulators and market participants through the publication of guidelines and reports. One way forward was the adoption by the ESAs in December 2016 of good supervisory practices for reducing mechanistic reliance on credit ratings, addressed to SCAs to better assess the use of contractual references in credit ratings and to mitigate their negative effect. Banking and insurance legislation also mandated the European Banking Authority to provide an objective **mapping of ratings by external credit assessment institutions (ECAIs)**, by establishing a correspondence between the rating categories of ECAIs and the risk weights under CRR and an allocation of ratings to an objective scale of credit quality steps under Solvency II. As most ECAIs' ratings were assigned the same mapping as the largest three CRAs mentioned above, they can now be used for capital relief purposes under the standardised, ratings-based approach by banks and by insurers under Solvency II, which should foster competition between CRAs.

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