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DRAFT REPORT

on credit rating agencies: future perspectives
(2010/XXXX(INI))

Committee on Economic and Monetary Affairs

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MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on credit rating agencies: future perspectives
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The European Parliament,

– having regard to the International Organization of Securities Commissions (IOSCO) note of March 2009 on 'International cooperation in oversight of credit rating agencies',

– having regard to the Joint Forum on 'Stocktaking on the use of credit ratings' in June 2009,

– having regard to the report of the Financial Stability Board to G20 leaders entitled 'Improving financial regulation', of 25 September 2009,

– having regard to the International Monetary Fund report of 29 October 2010 entitled 'Global Financial Stability Report: Sovereigns, Funding and Systemic Liquidity',

– having regard to the declaration of the G20 Toronto Summit of 26 and 27 June 2010,

– having regard to the report by the Financial Stability Board on 'Principles for reducing reliance on CRA ratings', of 27 October 2010,

– having regard to the public consultation launched by the Commission on 5 November 2010,

– having regard to Rule 48 of its Rules of Procedure,

– having regard to the report of the Committee on Economic and Monetary Affairs (A7-0000/2010),

A. whereas it welcomes the ongoing work at global, international and European level on the regulation of credit rating agencies (CRAs),

B. whereas CRAs are information intermediaries, reducing information asymmetries in the capital markets and facilitating global market access, reducing information costs and widening the potential pool of borrowers, thus providing liquidity to markets and helping find prices,

C. whereas, in recent legislation, CRAs have been assigned another role which can be classified as one of 'certification', reflecting the fact that ratings are increasingly embedded in regulatory capital requirements,

D. whereas CRAs rate three different sectors, the public sector, companies and structured finance instruments, and whereas CRAs played a significant role in the build-up to the financial crisis through the assignment of faulty ratings to structured finance instruments, which had to be downgraded on average three to four notches during the crisis,

E. whereas Regulation No 1060/2009 was the first reaction to the financial crisis and already deals with the most pressing issues, subjecting CRAs to oversight and regulation; whereas, however, it does not address all the fundamental problems and, in fact, creates some new barriers to entry,

F. whereas the industry's key problem is lack of competition and the regulatory system's key problem is dependency on external credit ratings,

G. whereas, in good times, market participants tend to mistake or disregard the underlying methodology and meaning of credit ratings, which seek to pin down the probability of default,

H. whereas there seems to be a lack of qualitative comparability in some of the three sectors of ratings,

I. whereas the recent developments in the euro crisis have highlighted the significant role of sovereign debt ratings,

Macro level: financial market regulation

Over-reliance

1. Considers that, in the light of the change in the nature of credit ratings, where the issuer is rated to get a preferential treatment under a regulatory framework rather than to gain access to the global capital markets, the over-reliance of the global financial regulatory system on credit ratings has to be reduced as far as possible and in a realistic timeframe;

2. Agrees with the principles set out by the Financial Stability Board in October 2010 giving general guidance on how to reduce reliance on external credit ratings, and welcomes the Commission's public consultation starting in November 2010; asks the Commission to review whether and how Member States use ratings for regulatory purposes;

3. Points to shortcomings in the standardised approach in the Basel II regulatory framework allowing regulatory capital requirements for financial institutions to be set on the basis of external credit ratings; supports increased use of the internal-ratings-based (IRB) approach, provided that the size and sophistication of the financial institution allow for an adequate risk assessment; considers, at the same time, that smaller and less sophisticated players should be able to use external ratings, if no internal credit risk assessment is viable, provided that they fulfil appropriate due diligence requirements;

4. Sees the need to restore investors' ability to conduct their own due diligence as a pre-requisite for enabling increased use of proprietary internal models for credit risk assessment; suggests that an incentive be created for banks and other financial players to conduct proper internal risk assessments;

5. Expresses the view that market participants should not invest in structured products if they cannot assess the underlying credit risk themselves, or alternatively that they should apply the highest risk weighting;

6. Asks the European Central Bank and the national central banks to review their use of external ratings, and urges them to build up expertise in devising their own models to assess the credit standard of eligible assets used as collateral for liquidity-providing operations, and to reduce their reliance on external ratings;

Increased capacity for supervisors

7. Is aware of the inherent conflict of interest if market participants devise internal credit risk assessments for their own regulatory capital requirements, and hence sees the need to increase supervisors' capacity and resources for monitoring, assessing and overseeing the adequacy of the internal models;

Level playing field

8. Highlights the global nature of the credit rating industry and urges the Commission and Member States to work on a global approach in order to preserve a level playing field and prevent regulatory arbitrage while keeping markets open;

Intermediate level: industry structure

European Credit Rating Foundation

9. Calls for a the establishment of a fully independent European Credit Rating Foundation (ECRaF) which would expand its expertise into all three sectors of ratings;

10. Believes that the start-up financing costs to cover the first three years of the ECRaF's work need to be carefully calculated; that these initial costs should take the form of a lump-sum capital payment and should be provided by the financial services industry with the involvement of both users and issuers; asks the Commission to produce a detailed impact assessment and cost estimate for the necessary financing in this respect; considers that the new ECRaF should be fully self-sufficient after the three-year start-up period;

11. Considers that, to ensure its credibility, the management, staff and governance structure of the new ECRaF need to be fully autonomous vis-à-vis the Member States, the Commission and all other public bodies;

12. Asks the Commission to conduct a detailed impact assessment and feasibility study on the establishment of an independent ECRaF and to come forward with legislative proposals;

Network of European credit rating agencies

13. Supports the establishment of a network of European CRAs; considers that nationally active CRAs should be encouraged to move to partnership or joint-network structures in order to draw on existing resources and staffing, thus enabling them to provide increased coverage and allowing them to compete with CRAs active at cross-border level;

14. Sees a potential need to support the initial set-up of such a network but considers that the network ought to be self-sufficient and profitable from its own revenue; asks the Commission to assess the necessity and potential means of start-up financing and possible legal structures for this project;

Disclosure and access to information

15. Points out that, in order to enable investors adequately to assess risk and to fulfil their due-diligence and fiduciary duties, increased disclosure of information is necessary in the field of structured finance instruments to allow investors to make informed judgments; considers that sophisticated investors should be able to rate the underlying credits from which they can then derive the risk of a securitised product;

16. Asks the Commission to propose a revision of Directive 2003/71/EC and Directive 2004/109/EC in order to ensure that sufficient accurate and complete information on structured finance instruments is available;

17. Ponders whether it would be advantageous to oblige issuers to discuss the content and method behind a structured finance instrument with a third party that is either conducting an unsolicited credit rating or devising an internal risk assessment;

Two obligatory ratings

18. Is of the opinion that the Commission should consider the use of two obligatory ratings for structured finance instruments if an external credit rating is used for regulatory purposes;

19. Considers that the costs of both ratings should be borne by the issuer and that the first rating should be by a hired CRA, at the choice of the issuer, while the second should be assigned by the European Securities and Markets Authority (ESMA) to a different CRA on the base of merit, taking historic performance into account;

Sovereign debt rating

20. Is aware of the fact that market players are averse to volatile credit ratings because of the high costs involved (in related sell or buy decisions) when ratings are adjusted; considers, however, that smoothing practices by CRAs make ratings more likely to be procyclical and to lag behind financial market developments;

21. Considers that, as almost all information on sovereigns is available in the public domain, larger and more sophisticated market players should use internal models to assess sovereign credit risk;

Micro level: business model

Payment models

22. Supports the existence of various payment models in the industry as long as inherent conflicts of interest are addressed by regulatory means; asks the credit rating industry to come forward with proposals for alternative viable payment models that involve both issuers and users;

Accountability, responsibility and liability

23. Considers that if credit ratings fulfil a regulatory purpose they should not be classified as mere opinions, and that CRAs should be held accountable for their credit ratings;

recommends therefore that CRAs' exposure to civil liability in the event of gross negligence be increased and that provisions to that effect be anchored in Member States' civil law;

24. Points out that the ultimate responsibility for an investment decisions lies with the financial market participant, i.e. the asset manager, financial institution or sophisticated investor;

25. Suggests that each registered CRA should conduct an annual review to assess its past credit rating performance and should compile this information in an accountability report for the supervisor; suggests that the ESMA should carry out random checks on accountability reports to ensure a high quality standard in credit ratings;

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26. Instructs its President to forward this resolution to the Council and the Commission and the governments and parliaments of the Member States.

EXPLANATORY STATEMENT

Introduction

CRA ratings fulfil several useful purposes, they aggregate information about the credit quality of issuers in a global environment with asymmetric information between debt issuers and investors, allowing issuers to access global and domestic markets, reducing information costs and widening the potential pool of investors, thus providing liquidity to markets and helping find prices. However, developments in the regulatory framework have made these "information intermediaries" to de facto "regulatory licensors".

The recent financial crisis has highlighted that there are three key problems in the industry: *lack of competition*, *over-reliance* on external ratings in the regulatory framework and no *liability* for ratings by CRAs.

Your rapporteur would like to stress that it is important to bear in mind that the potential measures to be taken should undergo the necessary impact assessments and scrutiny and should not be a shot from the hip that would increase the barriers to entry and the risk of more conservative ratings, with according effects on the real economy and lending.

Your rapporteur looks at the matter using a top-down approach firstly assessing the macroeconomic role of CRA in the global financial market regulation and then looking at the intermediate level and questions of competition and the industry structure. Finally your Rapporteur assesses conflicts of interest in the business model, i.e. the micro level.

During this discussion the coordination of a global approach should be at the forefront of our ideas as this is a truly global industry with an underlying global capital market. It is thus important to be aware of the developments in the USA.

Macro

Over-reliance and dependency on external credit ratings

Eliminating as much as feasible and in a realistic timeframe the dependency on external credit ratings of the whole system is the first intention of this report. The role of external ratings as hard triggers plays a particularly high role when downgrading from investment grade to sub investment grade occurs. Your Rapporteur supports the principles expressed by the Financial Stability Board[1] and the more concrete proposals mentioned in the European Commission Public Consultation[2], however he also thinks that this needs to go hand in hand with increasing the ability of financial market participants to assess risks and a better understanding of the meaning of credit ratings as such.

There is a need in this respect to differentiate between the three market sectors that a CRA rates: corporates, public sector and structured finance instruments. The problem of overreliance is particularly present in the field of structured finance instruments, where the most corrections pointing to a rating failure had to be made. Your rapporteur is hence of the opinion that in case of a structured finance instrument, market participants should only be able

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[1] Financial Stability Board from 27 October 2010 " Principles for Reducing Reliance on CRA Ratings"

[2] European Commission Public Consultation from 05 November 2010 "Public Consultation on Credit Rating Agencies"

to invest in such an asset if they can prove to have an understanding and ability to assess the credit risk involved in such a product or they alternatively have to use the highest capital risk weighing for regulatory purposes.

Reliance in standards, laws, regulations, for example the increased use of external credit ratings for setting regulatory capital requirements, needs to be eliminated or decreased as much as possible. Differentiation according to the principle of proportionality is necessary in order to account for the different sizes and levels of sophistication of financial institutions. As less sophisticated institutions do not have ability and economic power to establish their own credit assessments, they will have to continue to rely on external ratings. Small players may still use external credit ratings, but only if they understand the risks involved and can conduct proper due diligence.

Not only the regulatory dependence but market reliance on external credit ratings in general needs to be reduced. The importance of ratings is growing in soft cases, such as investment policies and fund rules or instruments of incorporation, suggesting a potential lack of due diligence. Your Rapporteur hence believes that we need to restore or increase investors' ability to conduct own due diligence and risk assessment.

Central Bank reliance on external credit ratings is another vital part of the dependency problem. The ECB decision on marketable assets for collateral regarding the liquidity providing operations is primarily based on the use of external credit ratings. This should clearly be revised.

Supervisors
In this context, regulators and supervisors have to be able to assess the use of proprietary internal models, allowing them to check the adequacy of the risk assessment process, as there is an inherent conflict of interests if financial actors can make up their own models to determine the level of regulatory capital requirements they need to hold.

This is a first step to reduce the need for ratings; however, in certain cases external credit ratings will still need to be used and may be useful. In order to reduce the dominance of the three big rating agencies we should discuss the possibility of making two ratings obligatory for structured finance products. Safeguards need to be built-in in order to prevent this system from becoming a 'guaranteed market' and the issue of who assigns the second rating needs to be carefully considered. This suggestion is in line with a current proposal in the US financial sector reform legislation.

Intermediate
The industry structure is the main problem for lacking competition, as barriers to entry are very high. The problem lies less in the number of credit rating agencies that are active but their local nature and focus on niche-products leading to little or no acceptance (or importance) in the global capital markets, making them unable to compete particularly in the case of regulatory standards.

ECRaF
Your Rapporteur thinks that the possibility of establishing a fully independent non-public European Credit Rating Foundation (ECRaF) should be discussed.

The financing needs of the new ECRaF should be estimated carefully and your Rapporteur suggests a one-off lump-sum payment to the foundation in order to ensure independence. This start-up financing should be enough for the first years of the new ECRaF, which shall be fully self-reliant after that period and finance itself in the market from rating fees. The new ECRaF would rate assets from all three sectors, public, companies and structured finance instruments and would hence have to be equipped with the necessary staffing and resources in order to ensure a high quality of ratings.
Your Rapporteur is well aware of the potential conflicts and problems of such a project. There is no guarantee that the new ECRaF will be able to establish a reputation and become a real new entrant in the CRA industry, as a prerequisite the governance structure and set-up have to allow for maximum credibility with unquestionable independence from any public authority, be it Member States, the European Commission or any other public body. This is particular important to ensure credibility when it comes to sovereign debt ratings

Network of CRAs
In addition, your Rapporteur suggests fostering the establishment of a network of European CRAs. The cooperation of nationally active CRAs to use the available staffing and resource capacities would potentially increase competition in the industry by covering a wide range of assets and different markets that allows being on a similar level as the big globally active CRAs. A need to create an incentive or a framework that will encourage smaller and regional CRAs to move to a partnership structure should be carefully discussed.

Disclosure
Your Rapporteur is of the opinion that in order to reduce the reliance on external credit ratings, it is necessary to increase the disclosure of information to investors in order to enable them to fulfil due diligence and fiduciary duties and to conduct own risk assessment as well as enabling other CRAs to rate an instrument even if not selected or nominated to rate it directly, i.e. an unsolicited rating.

This is a general point that should be addressed in the future provisions in the CRD reviews but needs to also be included in a revision of the Prospectus Directive and Transparency Directive. In particular the Prospectus Directive would have to be changed for structured finance instruments, which is the only way to get information in the market and enable participants also to be less reliant on ratings.

This could potentially also lead to less pro-cyclicality as downgrades would not immediately lead to sell-off of assets, as investors could conduct their own assessment and do not fully rely on external ratings that could trigger selling or buying decisions.

Sovereign Debt Ratings
CRA use smoothing techniques in order to make their sovereign ratings less prone to volatility. This is due to high potential costs involved for market players if ratings are adjusted (connected to potential sell or buy decisions). This makes ratings more procyclical and exhibits "cliff effects". The timeliness of sovereign ratings is problematic as governments publish different data at different times and the reliability of data can sometimes be questionable. Sovereign ratings have only started playing a major role in the past years. Your Rapporteur is of the opinion that in the case of sovereign debt ratings there is very little need to rely excessively on external credit ratings as almost all information is available to the

public. Hence all sizeable and sophisticated market participants should rate sovereigns themselves and not rely solely on external credit ratings.

Micro

Payment Models

The issuer-pays model has replaced the subscriber-pays model that was prevalent until the 1970s and has become the new norm. All payment-models have flaws or practicability questions which make them difficult to consider as true alternatives.

The disadvantages of the issuer-pays model with intrinsic conflicts of interest can be addressed by prohibiting CRAs to provide advisory services and making the board of directors more independent.

The subscriber-pays model has intrinsic problems: large investor could try to influence CRAs to provide lower ratings (higher yield) or in turn financial institution that wants to push capital requirements down may exert pressure for higher rating due to regulatory requirements. The subscriber-pays model neglects the fact that ratings have become a quasi public good. This type of model would also lead to a large free-rider problem of non-subscribers in a global and information based society.

The performance-based pay model that only charges a small up-front fee and the remainder of the fee is earned over time based on the accuracy of the rating, fits with the approach in other regulation such as remuneration in CRD, but this concept needs a substantial amount of work on the regulatory and supervisory side to make it feasible.

Your Rapporteur favours the existence of various models in the market as long as inherent conflicts of interest are addressed by regulatory means.

Accountability

In a well-functioning competitive market, reputation is enough to ensure the quality of credit ratings. But as the current structure is oligopolistic, CRAs face an intrinsically 'guaranteed market' which means that the effect of a loss of reputation is negligible, i.e. there exists no credible threat to loose reputation.

Your Rapporteur considers that credit ratings are not just pure opinions but that CRAs should be accountable for their ratings and that therefore their exposure to civil liability should be enhanced in order to provide a credible threat.

As the introduction of liability poses certain questions like when a CRA becomes liable and for which failures as well as how this can be set-up without introducing another additional barrier to entry to the market, this aspect merits a particular thorough discussion.