European Securities and Markets Authority

Date: 16 May 2011
ESMA/2011/142

Keynote address of Steven Maijoor, Chair of ESMA, to the Bundestag panel discussion. Berlin, 16 May 2011

Ladies and Gentlemen,

It is a great pleasure for me to open this conference here at the German Bundestag.

Today, I would like to talk about the supervision of Credit Rating Agencies (CRAs) in the European Union (EU). Important elements of that discussion are the lessons learned from the financial crises, the role that ESMA plays regarding CRA supervision, and the challenges that we face in the upcoming months and years.

Let me start with the subject of CRAs and the lessons from the financial crisis.

At the beginning of the crisis, CRAs were heavily criticized for being far too optimistic: this related to their role regarding structured products. Now they are criticized for being too pessimistic: this is related to their role in rating sovereign debt. Considering these opposing directions of criticism both areas of criticism merit further discussion.

Major CRAs played a key role in the near financial meltdown at the start of the financial crisis. The so-called "CDO machine" would not have worked without the active role played by the leading CRAs. They have contributed to lower the perception of credit risk by giving top credit ratings to the senior tranches of complex structured products. The inflation of credit ratings was accompanied by a major underestimation of the credit default risks of such instruments. These flaws were the result of inaccurate rating methodologies. The conflicts of interest in CRAs made matters worse. The issuer-pays model, and the drive for more profits resulted in the accommodation of investments bankers bringing the business. Issuers shopped around CRAs to ensure they could get an AAA rating for their products. Considering that we are now able to look back at the ratings given to structured products we have objective measures of the very poor performance of ratings in this area.

The issues related to sovereign debt ratings are of a different nature. The European sovereign downgrades highlight the risks from spill overs across countries and financial markets. Downgrading of one country might trigger downgrades of other countries. And as ratings affect borrowing costs, there is the risk of a self-fulfilling prophecy. These potential stability effects of ratings only reinforce the importance of strong CRA supervision.

CRAs have been criticised for downgrading sovereigns and thereby increasing their fiscal problems. However, it is clear that there are serious fiscal problems in downgraded countries and we do not yet have the historical perspective which we have for the structured product ratings. This makes judging the perform-

ance of sovereign debt ratings more difficult. Indeed, given the difficulty in judging the performance without the benefit of time, suggests strongly the need to avoid overreliance on ratings.

Now let's talk about the supervision of CRAs in the EU.

Given the failures in the financial crisis it is only logical to establish a solid regulatory and supervisory framework for CRAs. Looking back, it is surprising that until recently we have relied on very light regulations, or no regulations at all, for financial institutions that have such an important role in financial markets.

There have been intensive debates as to how best to ensure effective and efficient regulation and supervision of CRAs. Several policy actions have been initiated and new regulatory frameworks have been introduced, both inside the EU and outside the EU, including the US. Having their lessons learned and confronted with increasing pressures from supervisors and the general public, CRAs have also taken actions. They have revised their models and methodologies, increased the disclosure and transparency and they have adjusted their internal structures and processes. Of course, this is also related to the fact that CRAs are now involved in the registration process and need to meet new requirements.

The first main EU regulatory inititiative is the CRA Regulation of September 2009, which I will discuss in more detail later in this speech. However, in December 2010 the European Parliament decided on a very important revision of this young regulation. As from the first of July, ESMA will be the sole supervisor of CRAs in the EU. National supervisors will remain responsible for the supervision of the use of credit ratings by financial institutions, and can request ESMA to withdraw the registration of a CRA. In addition, ESMA may also delegate specific tasks to national authorities, in particular in respect of the on-site inspections.

This new Regulation is a major change of the European framework of CRA supervision compared with the previous regulation adopted in September 2009. This change is only very logical considering that credit ratings are used throughout the EU. Also, a model with supervisory colleges is not an optimal solution when CRAs are active in a large number of Member States. Therefore, the establishment of ESMA combined with the decision for one EU CRA supervisor is very logical.

Let me now focus on the EU regulatory framework and supervision.

The new Regulation on CRA, the so called CRA II, was passed on 11 May and will be issued within the coming days. The new framework will very substantially increase the regulatory and supervisory powers of ESMA regarding CRAs established in the EU.

Indeed, all competencies and duties related to supervisory and enforcement activities in the field of credit rating agencies**,** which were conferred on the competent authorities, will move to ESMA on the first of July 2011. From this date, ESMA will be exclusively responsible for the registration and supervision of credit rating agencies in the Union. The only exception to this, is that applications for registrations that were received by 7 September 2010 and which will be decided on by national competent authorities and colleges of supervisors established for the registration of EU cross border CRAs.

Three main elements of the European regulatory approach to CRAs can be identified, namely the (1) **registration requirement**; (2) **rules of conduct** for registered CRAs; and (3) the **supervision** of registered CRAs.

1. Registration

Between 7 June and 7 September 2010 CESR has received 23 applications for registration in the EU, and 1 for certification. At the moment, 2 German CRAs are registered in the EU and 1 Japanese CRA through the certification procedure. Another local EU CRA is in the process of being registered very soon.

The registration procedure is based on two successive assessment phases: the completeness phase and the compliance phase. Recently, critical remarks were expressed regarding the speed of the registration process. On this point, I would like to make clear that we have worked within, and met all the deadlines as envisaged in the regulation. Some registrations have taken more time because of incomplete applications, the complexity of the registrations or requests for exemptions.

We expect that apart from the big international CRAs, the registration process of the CRAs only established in the EU[1] will be completed in the next couple of weeks. Given the world-wide dimension of the big CRAs, we anticipate that their registration process will be completed this summer.

The CRA Regulation applies to credit ratings issued by CRAs registered in the EU and which are disclosed publicly or distributed by subscription. In order for a CRA with a registered office outside the EU to be able to qualify for registration, it has to set up a subsidiary in the EU and thus using the endorsement system or, for a CRA without a physical presence in the EU, to use the certification procedure also foreseen in the Regulation. These approaches seek to ensure one of the aims of the Regulation, which is the effective and efficient supervision of the activities of CRAs located outside the EU.

2. The European rules of conduct for CRAs

The European regulatory regime builds on a combination of specific rules of conduct and, more generally, enhanced transparency and prevention of conflicts of interest between CRAs and their most important clients.

Credit ratings for structured finance products must ensure that those credit ratings are clearly differentiated using a symbol, which distinguishes them from rating categories used for any other entities, financial instruments, or financial obligations.

In addition, registered CRAs are also obliged to disclose to the public the methodologies, models, and key rating assumptions used in its credit rating activities as well as their material changes. In the case of the adjustment of the methodologies, models, or key rating assumptions the CRA must immediately disclose the likely scope of credit ratings affected by this change and review and possibly re-rate them promptly. CRAs must also continually review ratings in order to prevent them from concentrating on the initial rating and neglecting subsequent monitoring against the background of macroeconomic or financial market developments.

Overall, the Regulation clearly aims at improving the transparency of CRAs, including about their past performance. With regard to the latter, CRAs must also disclose ratings on a non-selective basis and in a

[1] As of today, 3 CRAs have been registered in the EU: Euler Hermes Rating GmbH (by Bafin, Germany). Registration date: 16 November 2010. Japan Credit Rating Agency Ltd (AMF, Japan), 6 January 2011. Feri EuroRating Services AG (Bafin). Registration date: 14.4.2011.

timely manner. This also applies to ratings that are only distributed by subscription. CRAs must also make available a list of the largest 20 clients by revenue. Additionally, CRAs must periodically disclose data on the historical default rates of rating categories and make available in a central repository – CEREP - information on historical performance. Finally, CRAs must publish an annual transparency report and keep extensive records of their activities.

Moreover, CRAs are obliged to disclose conflicts of interests in a complete, timely, clear, concise, specific, and prominent manner and record all significant threats to the rating agency's independence or that of its employees involved in the credit rating process. These threats to independence must be published together with the safeguards applied to mitigate those threats. At the same time, CRAs may no longer provide consultancy or advisory services to the rated entity or a related third party.

Last but not least, the Regulation seeks to address potential conflicts of interests in the rating process by obliging CRAs to introduce adequate internal policies and procedures to insulate rating analysts, employees and other persons involved in the rating activities from conflicts of interest and ensure appropriate rotation arrangements for analysts and persons approving credit ratings for a particular entity.

3. Supervision

The new CRA regulation provides ESMA with a range of supervisory tools and measures, including the temporary prohibition of issuing a rating. Other tools are the suspension of the use of credit ratings for regulatory purposes with effect throughout the EU, the issuing of public notices when a CRA breaches the obligations set out in the Regulation, the possibility to refer matters for criminal prosecution to the competent jurisdiction, and ultimately the withdrawal of the registration. For this purpose, ESMA has "all the supervisory and investigatory powers that are necessary for the exercise of their functions" including the possibility of on-site inspections without prior announcement.

In this regard, the new regulation requires ESMA to conduct at least one inspection of all registered CRAs falling under its supervisory competences by 1 July 2014. These inspections will start after the summer this year.

Finally, ESMA is empowered to impose a periodic penalty payment to put an end to an infringement by a CRA, or can adopt a decision to fine a CRA that has committed one of the infringements listed in the new Regulation.

I would now like to talk briefly about the international aspects of CRA supervision.

Given that CRAs play a prominent role in all financial markets, many jurisdictions are now considering ways to regulate CRAs. This worldwide development is of course also backed by the G20 road map.

As the larger CRAs operate across borders, ESMA is currently considering the application of a set of requirements allowing the use of ratings issued in a non-EU country. Those requirements respond to the need to avoid a fragmentation in the supervision of CRAs activities while enhancing the ability of supervisors to oversee the CRA industry globally and to properly ensure the protection of the European users of credit ratings.

Regarding credit ratings issued in non-EU countries and used by EU investors or financial institutions, ESMA expects to issue Guidelines very soon on how to implement the "as stringent as" test for credit

ratings produced outside the European Union, in so-called “third countries”. Essential for these Guidelines, will be that European users of ratings should have the same level of protection, regardless whether the rating is issued inside our outside the EU. At the same time, we will need to avoid any market disruptions as when we move to these new requirements for ratings issued outside the EU, and to ensure that sufficient ratings continue to be available for European users such as financial institutions.

We have been mandated by the European Commission to review the equivalence of related legislation of various countries, including Australia, Canada, Japan and the US, and we have been carrying out some initial work on a further number of jurisdictions such as Hong Kong and Singapore. CESR has found Japan to be fully equivalent and the Commission has established this equivalence through a formal decision in September 2010. Regarding the US, it was found to be broadly equivalent in May 2010, however, ESMA is monitoring the improvements to the legislation anticipated by the Dodd-Frank Act and will be able to finalise its assessment as soon as the draft secondary legislation is disclosed by the SEC. Work is continuing on the regimes of Canada and Australia.

Let me conclude by briefly talking about possible further changes to the regulatory framework for CRAs.

In the fall of 2010, the European Commission has consulted on possible new initiatives regarding CRAs. I fully support this continued debate on the proper framework for the sector. One issue that has come clearly out of this debate is the need to limit mechanistic reliance on ratings. There is broad support for this need, although we should realize that there is a limit to reducing reliance: as I stated earlier, CRAs are simply an important and inevitable element of well-functioning financial markets.

Another remark that I would like to make is that I am a bit cautious to make at this stage further fundamental changes to the current newly created supervisory system. The new supervisory framework needs to be implemented and to have its full effect on the way in which CRAs work. Once the new system has its full impact on the day-to-day operations of CRAs, we can better assess where further improvements are needed.

This word of caution is not at all a sign of complacency. It is clear to me that if the industry and the new supervisory system do not deliver a proper functioning system this time, it will dramatically affect the reputations of all parties involved and further sweeping changes will then be unavoidable. Hence, we all have strong incentives to make the new system work.

I thank you for your attention