European Securities and Markets Authority

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Credit Rating Agencies: What are the next steps?

Speech by Verena Ross at a public hearing organised by the Committee on Economic and Monetary Affairs of the European Parliament, 24 January 2012 in Brussels

1. Introduction

Dear Vice-Chair, honourable Members of Parliament, Ladies and gentlemen,

First of all, thank you very much for inviting me today to outline ESMA's view on the new legislative proposal concerning credit rating agencies (CRAs).

Let me begin my short remarks by saying a few words about ESMA's current work on CRAs. ESMA is currently in the process of fully implementing the provisions of the amended Regulation on credit rating agencies ("Regulation"), also known as CRA2. In particular, it is only since 1 July 2011 that ESMA has taken on responsibilities for the day to day supervision of registered CRAs. With the registration of the major CRAs on 31 October last year, ESMA has immediately taken direct supervisory steps. We have conducted a first on-site inspection of the three main CRAs in December 2011, for which we expect to publish an examination report by the end of the first quarter of this year. In the course of 2012 we will also finalise the establishment of the reporting data tools provided by the Regulation and of the CEREP central database – an essential disclosure facility for investors. We are also in the process of performing the assessment of the regulatory framework of several non-EU countries and agreeing suitable cooperation arrangements with the respective supervisors - something that will ensure the endorsement of the overwhelming majority of third-country ratings currently used for regulatory purposes in the Union.

2. CRA 3 Proposals

a) Measures increasing disclosure, addressing conflicts of interest, and introducing civil liability

As for the CRA3 proposal, I personally believe several proposed provisions would have a positive effect on the overall framework for CRA supervision, starting with the new **disclosure provisions:** a) for instance the fact that issuers, sponsors, and originators of structured finance instruments would have to disclose information on the credit quality and performance of underlying asset pools; or b) that CRAs should disclose to ESMA the fees received from each of their clients and their general pricing policy.

Another important contribution of the new proposal concerns the **prevention of conflicts of interest.** This provision states that CRAs shall not issue credit ratings when their major shareholders have interests in the rated entity or when the rated entities are major CRA shareholders themselves. Major CRA shareholders would also be limited in their ability to provide consultancy or advisory services to the rated entity. Moreover, we look with interest at the proposal to limit major cross-shareholdings among CRAs. While it will be important to get the exact provisions right, reducing any real or apparent conflicts of interest between CRAs and their shareholders is an important step in the right direction.

Another area which in my view is positive, is the proposal requiring ESMA to introduce a **harmonised rating scale** to be used by all CRAs registered in the EU. As has been observed, there may be a limit to the ability of market participants to consider and compare different rating scales and methodologies. The uniform rating scale would establish a comparable metrics for all existing rating scales. Such metrics would contribute to the transparency, interoperability, and comparability of the rating process and could enhance competition in the sector.

Furthermore, the proposal helpfully provides that Member States shall ensure **civil liability** for any infringements to the CRA Regulation made with intention or gross negligence. An efficient liability regime could encourage CRAs to adopt even stronger credit rating processes, which were lacking in the structured product space a few years ago. Moreover, the proposal could help to ensure continued strong quality rating processes by all CRAs, which - as I will describe further below - might benefit from the mandatory rotation proposals. Although we agree with the Commission choice to rely on the procedural rules in existence in the EU Member States, careful thought should be given to the possible interactions and inconsistencies among them. Careful consideration also needs to be given to the incentives deriving from the partial inversion of the burden of proof, so as to ensure a truly balanced liability regime that achieves the desired outcomes.

b) The need to evaluate the impact of other provisions

Having just spoken about the proposals which I see great benefit in introducing, let me also add a word of caution on a few of the provisions in the CRA3 proposals where I believe the implications need to be carefully considered.
In the first place, the proposal introduces the requirement for ESMA to **assess new draft methodologies** as a condition for their entry into force. The proposal rightly states that ESMA will continue to refer to the same criteria for its assessment as under the present Regulation, which guarantee the non-interference in the rating process. However, from our current (admittedly limited) supervisory experience, this new proposed role for ESMA could create serious tensions with the requirement of non-interference and independence. One possible alternative could be to have detailed principle-based industry standards for rating processes – similar to many other parts of the financial markets – the application of which ESMA could then monitor as part of its on-going supervision process to ensure that the CRAs respect these commonly agreed industry standards.

Secondly, the CRA3 proposal introduces several provisions on **mandatory rotation** for rating analysts and CRAs. I fully support the Commission's aim to achieve greater competition in the CRA sector, which might have been hampered by investors and users of ratings relying mainly on the most established CRAs. Having said that, at least in the short term, there is a risk that new entrants might compete by offering higher ratings or by lowering prices. This could have a detrimental effect on the quality of the rating process and the reliability of the ratings themselves. If new entrants or smaller CRAs are attracted to bid in the rotation process, it is not clear that - at least in the short term - their professional competence (such as adequate staffing, processes, systems, controls, etc) will be able to live up to expectations. These risks might only be short-term growing pains, well worth it for the greater good of enhanced competition, but I believe we need to be careful of the potential impact these risks might have on the quality of the credit rating market at this important time.

Let me also mention one area of the proposal which requires ESMA to branch out to new supervision tasks. This is the requirement that ESMA annual report shall **assess market concentration levels and related risks**. Such tasks normally belong to competition supervisors. While ESMA will of course stand ready to fulfil the tasks provided to it by legislators, ESMA would have to adopt entirely new skills and methodologies to assess risks from market concentration levels. But apart from that practical challenge, it should be clear that ESMA might find itself in the uncomfortable position of pursuing possible conflicting objectives such as ensuring the stability and the competition of the securities markets at the same time.

Finally, please allow me to raise two aspects of the proposal that have a direct bearing on ESMA working processes which are of concern to ESMA staff.

First, the proposal requires ESMA to renew by 1 June 2014 the assessment of **compliance of third-countries with the amendments introduced by the CRA3**. The Regulation currently in force already requires ESMA to judge dynamically the adequacy of the regulatory framework in non-EU countries when compared to the EU Regulation, namely that the third-country legal framework achieves similar regulatory effects and meets the same objectives as the EU Regulation. By adding in the CRA3 proposals a tight deadline and by making a direct reference to the CRA3 amendments, the proposed (from scratch) assessment would not only run into difficulties since at the moment several of the CRA3 proposals are not part of the G20 and IOSCO framework, but might also create incredulity of ESMA's intentions and good faith in the continuing ongoing third-country assessment process that we are currently engaged in under the existing Regulation.

Secondly, I have to repeat my message on giving **ESMA sufficient time to adopt the new Regulatory Technical Standards** in the proposal. The deadline for the task of finalising the Technical Standards – 1 January 2013 - is very close to the probable final adoption date of the new Regulation. ESMA should be given proper time (we continue to say that this means 'one year') to draft, consult on and agree these new standards, to ensure they are of the quality the Parliament rightly expects of ESMA.