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EU and US Developments in the Regulation of Credit Rating Agencies

The role played by credit rating agencies ("**CRAs**") in the global economy has been under scrutiny on both sides of the Atlantic since the credit crunch took hold in the second half of 2007. Among other matters, governments and financial market regulators have been caught off guard by the sudden meltdown in the asset backed securities market and the fact that many of those securities that are currently illiquid, and in many cases performing at considerably less than full value, had solid investment grade ratings.

A series of government hearings and committee meetings has been held in various European capitals and in Washington before which representatives of various CRAs have appeared. In Europe, the European Commission (the "EU Commission") has published a proposal for a new Regulation. In the US, the regulatory response has centred on the implementation of new rules under the Credit Rating Agency Reform Act. This memorandum summarises the key elements of the proposed EU Regulation and of recent changes in the US to the rules implemented under the Credit Rating Agency Reform Act. The introduction of heightened regulatory standards for CRAs in the EU is long overdue. This memorandum will, in addition to the above, highlight issues arising from the EU Commission proposals which require further deliberation on the part of Community legislators.

EU Commission Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies

On 12 November 2008, the EU Commission published a proposal for a Regulation on CRAs aimed at restoring market confidence and ensuring investor confidence.[1] The EU Commission's heightened regulation of CRAs has been both welcomed and accepted as a timely response in light of recent economic developments. The proposal establishes a compulsory registration process for CRAs which operate in the EU, along with conditions for the issuance of credit ratings. The Regulation, if enacted by the European Parliament and Council, would bring the EU into line with the US, where there has been a registration and supervision requirement since mid-2007.[2] Given that the US is the country of incorporation for most of the parent companies of CRAs active in the EU, CRAs should be able to implement the proposals without too great an impact. It should be noted that the EU Commission proposals have attracted criticism on the grounds that increasing regulation will heighten barriers to entry and by tying CRAs more closely to the regulatory framework, there is a danger that they are perceived to be infallible. The result, it is argued, is that it would be a more expensive and less efficient ratings industry due to the costs associated with regulatory compliance and restricted competition. This argument should however be

[1] The Proposal can be found at http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

[2] US Credit Rating Agency Reform Act 2006 (in force 27 June 2007).

dismissed on the grounds that self-regulation has failed and the industry has remained effectively an oligopoly.

Overview

The EU Commission recognises that CRAs 'contributed significantly to recent market turmoil' through their rating of structured credit products.[3] In underestimating the risk of these financial instruments and by failing to reflect the worsening market conditions early enough in their ratings,[4] CRAs indirectly encouraged investment in these products. CRAs have consistently performed worse in rating structured products than in issuing traditional ratings. Therefore the proposed Regulation is focused mainly on addressing the poor performance in relation to structured credit products.

The EU Commission aims to create a common approach to regulation of CRAs throughout the EU, avoiding diverging measures at a national level, and as a result proposed that a Regulation be the legislation adopted.[5] The main objective of the EU Commission proposal is to ensure that ratings are reliable and accurate pieces of information.[6] More specifically, the EU Commission aims to:

- Ensure that CRAs avoid and manage appropriately any conflict of interest.
- Ensure that CRAs remain vigilant on the quality of the rating methodology and the ratings.
- Increase the transparency of CRAs.
- Ensure an efficient registration and surveillance framework to prevent forum shopping and regulatory arbitrage.

3 Para. 1.1, Explanatory Memorandum to the Proposal.

4 Recital 5.

5 Regulations have direct effect in each member state, and provisions of the regulation can therefore be relied on and enforced in national courts: Treaty of Rome 1957, Article 249.

6 Impact Assessment: para. 4.

Background

In February 2004, the European Parliament adopted a resolution on the role and methods of CRAs.[7] Following advice received from the Committee of European Securities Regulators ("**CESR**") in March 2005,[8] the EU Commission decided that further legislation to regulate CRAs was not required. The current regulatory approach to CRAs active in the EU is based on voluntary compliance with the International Organisation of Securities Commissions ("**IOSCO**") code of conduct,[9] and a yearly assessment by the CESR. CRAs are currently only subject to Community legislation to a limited extent – they are referred to in the Market Abuse Directive[10] and the Capital Requirements Directive[11] (in the determination of risk weights of a firm's or bank's exposures which are relevant to capital requirements).

In autumn 2007, following deterioration in the financial markets, the EU Commission asked the CESR and the European Securities Markets Expert Group ("**ESME**")[12] to provide advice on CRAs, especially focussing on structured finance. Following the reports of CESR and ESME (on 13 May 2008 and 4 June 2008 respectively), and after holding its own discussions with various stakeholders, the EU Commission decided that a Regulation was required to 'restore confidence of the market in the ratings business in the European Union'.[13] The proposed Regulation adds to the EU Commission's other proposals to deal with the financial crisis on matters including the Capital Requirements Directive, Solvency II, and Deposit Guarantee Schemes. Since the EU Commission considers that the revised IOSCO code of conduct is the 'global benchmark',[14] the proposed

7 2003/2081(INI).

8 CESR/05/139b.

9 http://www.iosco.org/library/pubdocs/pdg/IOSCOPD271.pdf.

10 Directive 2003/6/EC.

11 Directives 2006/48/EC and 2006/49/EC.

12 The European Securities Markets Expert Group (ESME) was set up in April 2006 as an advisory body to the EU Commission.

13 Charlie McCreevy, Internal Market and Services Commissioner.

14 Explanatory Memorandum to the Proposal, para. 1.1.

Regulation gives many of the provisions in the IOSCO code binding force, as well as implementing a compulsory registration process. If adopted by the EU Parliament and Council, the proposed Regulation will apply to CRAs six months after its publication in the Official Journal of the EU.[15]

Registration Process

The EU Commission proposes that a legally-binding registration regime is enacted for CRAs that want to ensure that their credit ratings can be used for regulatory purposes.[16] A CRA registered in one Member State can issue credit ratings anywhere in the EU.[17] Once registered, a CRA will be entered on an updated list in the Official Journal of the European Union.[18]

Under the proposed Regulation, each Member State is required to designate a 'competent authority'.[19] These competent authorities will have supervisory and investigatory powers, but may not interfere with the content of credit ratings.[20] They will make the ultimate decision on registration and may charge a registration fee proportionate to the cost of procedures in the home Member State.[21] As noted below, CRAs that wish to issue credit ratings within the EU must have a registered office in a Member State.[22] The competent authority for a CRA will be the competent authority in the Member State in which the CRA has its registered office. However, competent authorities may not impose more onerous requirements on registration than those provided for in the Regulation.

CRAs will be required to submit an application for registration to the CESR, containing the information required by Annex II to the Regulation (including details of the CRA, a description of the procedures and methods used to issue credit ratings, policies and procedures to identify and manage conflicts of interest, and information about employees).[23] The application will be transmitted by the CESR to the competent authority of the home Member State within 10 days. The decision to register or refuse registration is made by the competent authority of the home Member State, although it will first send a draft decision to the CESR. Once a decision is made, the competent authority will notify the EU Commission, the CESR, and the competent authorities of other Member States within the required time frame.[24]

Registration must be withdrawn by the competent authority of the home Member State in certain circumstances. These are where the CRA expressly renounces the registration, has provided no credit ratings for the preceding six months, has made false statements in obtaining the registration, no longer meets the conditions under which it was registered, or has infringed the provisions of the Regulation which deal with operating conditions.[25] The competent authority will notify the EU Commission, which will update the list of registered CRAs in the Official Journal of the European Union within 30 days.

The current drafting and explanatory notes to the Regulation are silent as to what happens if the competent authority withdraws a registration. For example, what would be the status and validity of prior ratings provided by a CRA that had lost its registration? This situation could lead to market uncertainty, the mitigation of which is the underlying rationale to the proposed Regulation. Community legislators should consider revising the drafting of the proposed Regulation to avoid this situation.

In order to allow for efficient supervision of all CRAs operating in the Community under the Regulation, those with headquarters located outside the EU but which want to operate in the Community are required to set up

15 Article 36.

16 Article 12.

17 Article 12(2).

18 Article 15(3).

19 Article 19.

20 Article 20.

21 Article 16.

22 Article 3(1)(c).

23 Article 13.

24 Article 15.

25 Article 17.

a subsidiary which can then be registered.[26] Following from this, the EU Commission proposals require refinement on the matter of credit ratings issued outside the EU. Under the proposed Regulation, institutions 'may only use for regulatory purposes credit ratings which are issued by CRAs established in the Community and registered in accordance with this Regulation'.[27] This has been interpreted by the market to mean that ratings must be created and assigned by employees of a registered agency located within the EU. This could mean, for example, that global credit rating activities would have to migrate to Europe in order to ensure that EU investors could continue to trade in US financial instruments. Community legislators should rethink how ratings issued by non-EU CRAs should be regulated. One approach would be to adopt a system of equivalence.

Disclosures

In order to enhance the transparency of the credit rating process and enable investors to make a more informed investment decision, the EU Commission proposes that CRAs must make various disclosures to the public. The EU Commission notes that investors should not rely blindly on credit ratings but should take the utmost care to perform their own due diligence and undertake their own analysis in deciding whether to trust a specific rating agency.[28] The proposed disclosures facilitate this.

The most important disclosures relate to the methodologies, models and key rating assumptions used in the rating process.[29] CRAs must disclose any credit rating on a non-selective basis and in a timely manner (unless the credit ratings are distributed by subscription).[30] Credit ratings must be presented in the required format, as set out in Section D of Annex I. Policies and procedures regarding unsolicited credit ratings must also be disclosed and identified with a different credit rating category. There are specific requirements for the rating of structured credit products (namely instruments resulting from securitisation transactions, which would include CDOs).[31]

Under the proposed Regulation, registered CRAs must publish an annual transparency report detailing their legal structure and ownership, financial information and internal systems.[32] Registered CRAs must also make full and public disclosure of matters relating to conflicts of interest (both actual and potential), policies relating to the publication of credit ratings, and ancillary services to the core rating business, amongst other matters.[33] Such disclosures must be kept updated, and CRAs must continually review any ratings. Each CRA is also required to periodically disclose data on the historical default rates of its rating categories and give competent authorities certain information such as the list of their largest 20 clients by revenue.[34] Under the Regulation, a central repository will be established by the CESR which will be open to the public and hold all the information on the historical performance and past activities of CRAs. These proposals should be extended further and make provision for the CESR not only to maintain the central repository but to also conduct random audits of ratings to evaluate their long-term validity and initial accuracy. Such measures may incentivise CRAs to issue ratings that are appropriate for the instrument under review and reduce the incidence of inflated ratings.

Independence

One of the aims of the proposed Regulation is to ensure that conflicts of interest are avoided or adequately managed, in order to uphold the quality and objectivity of credit ratings. Article 5 places a duty on CRAs to ensure that the issuance of a credit rating is not affected by any actual or potential conflict of interest. In doing so, the

[26] Recital 27.

[27] Article 4.

[28] Recital 5.

[29] Article 7.

[30] Article 8.

[31] Article 8(3); Annex I Section D Part II.

[32] Article 10; Annex I Section E Part III.

[33] Article 9; Annex I Section E Part I.

[34] Article 9; Annex I Section E Part II.

CRA is obliged to comply with various requirements.[35] The most important requirements are outlined below. In addition, CRAs must ensure that employees involved in the rating process have the appropriate knowledge and experience and are not involved in any negotiations on fee arrangements between the CRA and the rated entity (or an affiliate thereof). Those employees directly involved in the credit rating process must meet various requirements (relating to maintaining their independence) and be subject to a rotation mechanism (whereby analysts are generally required to provide rating services to an entity for between two and four years).[36] Compensation arrangements for employees involved in the rating process must be determined primarily by the quality, accuracy, thoroughness and integrity of their work.[37]

The key independence requirements are as follows:

- *Management*: CRAs must have an administrative or supervisory board, responsible for ensuring the independence of the rating process. The board will also ensure that conflicts of interest are properly identified, managed and disclosed, and check the compliance of the CRA with the requirements of the Regulation. The senior management of a CRA must be of good repute and sufficiently skilled and experienced. There must be at least three independent non-executive members on the board, and their term of office must not be longer than five years. They can only be dismissed in cases of professional misconduct or underperformance. The remuneration of the independent members of the board cannot be linked to business performance of the CRA. At least one of the independent members of the board should be an expert in securitisation and structured finance.
- *Services provided*: CRAs should limit their activity to credit ratings and related operations, excluding consultancy or advisory services.
- *Monitor credit ratings*: CRAs must have information of a sufficient quality (and from reliable sources) on which to base their ratings,[38] and an internal function must be created to review the quality of these ratings.
- *Records*: CRAs must keep records of all their activities for at least five years. If registration is withdrawn, the records should be kept for at least three years.

Guidance

Under the proposed Regulation, the CESR is to issue guidance and provide advice to the competent authorities of Member States.[39] It is also to report yearly on the application of the Regulation.

Enforcement

In order to ensure the effective enforcement of the Regulation, the EU Commission proposes that Member States should lay down penalties for infringement which are effective, proportionate and dissuasive, and must notify the provisions enacted to the EU Commission.[40] The penalties should at least cover cases of gross professional misconduct and lack of due diligence. The EU Commission proposals do not however prescribe specific penalties for infringements of the Regulation, generating the potential for gross disparities between those levied by different Member States. Further, the proposed Regulation does not directly address the issue of CRA liability.

The proposed regulation requires cooperation between the competent authorities of different Member States.[41] A mediation mechanism should be established by the CESR to resolve any disagreement between competent authorities.[42] There are also provisions for an exchange

[35] These requirements are found in Sections A and B of Annex I.

[36] Article 6.

[37] Article 6(6).

[38] Article 7(2).

[39] Article 18.

[40] Article 31.

[41] Article 23.

[42] Article 27.

of information with non-EU countries, provided that guarantees of professional secrecy are in place.[43]

The dual-level system of national supervision of an EU Regulation poses the problem of coordination and the EU Commission proposal should be further refined in this respect. Provisions to confer upon the CESR the power to coordinate cross-border supervision are necessary to ensure regulatory standards are consistently maintained in every country. These provisions would circumvent the issue as to whether Member States will adopt the EU Commission's approach, which is based on a stronger role for the 'competent authority' where the CRA is based. Such measures at Community level should also facilitate any future proposals for an international regulatory agency which, given the global nature of the industry and prevailing market sentiment, may be the next stage of reform.

Recent US Developments on Credit Rating Rules

In early December 2008, the U.S. Securities and Exchange Commission (the "**SEC**") approved a number of changes to its credit rating rules. The final rule was released February 2, 2009 with an effective date of April 10, 2009. These changes developed out of the SEC staff's extensive 10-month examination of three major CRAs or nationally recognized statistical rating organizations ("**NRSROs**") and are aimed to further increase transparency and accountability at NRSROs.[44] The new rules supplement the rules implemented by the SEC under the Credit Rating Agency Reform Act in June 2007.[45]

SEC Final and Proposed Rules

The SEC's new credit rating rules affect NRSROs' record keeping procedures, conflict of interest rules, annual reporting methods and disclosure practices.

Three new record keeping rules require an NRSRO:

- to make and retain records of all rating actions related to a current rating;
- to make a record documenting the rationale for any material difference between the credit rating implied by a quantitative model used and the final credit rating issued if the model is a substantial component of the credit rating process; and
- to retain records of any complaints regarding the performance of a credit analyst in determining or maintaining a credit rating.[46]

In connection with the record keeping rules, an NRSRO must make publicly available a random sample of 10% of the issuer-paid credit ratings and their documented histories for each class of credit rating for which the NRSRO is registered and has issued 500 or more ratings.[47]

The SEC has also adopted new conflicts of interests rules for NRSROs that prohibit:

- an NRSRO from issuing a credit rating where the NRSRO has made recommendations to the issuer in respect of the structure of the financial instrument that is to be rated or in respect of the issuer's activities;
- personnel of the NRSRO who are responsible for determining the credit ratings from participating in any fee discussions and negotiations; and
- credit analysts who participated in determining the credit rating from receiving gifts, including entertainment, in excess of $25 (other than in limited circumstances such as business meetings) from the rated issuer.[48]

[43] Article 29.

[44] SEC Press Release dated 12/03/08 at: http://www.sec.gov/news/press/2008/2008-284.htm

[45] SEC Press Release, Fact Sheet dated 12/03/08 at: http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm

[46] *Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 34-59342 (February 2, 2009) ("SEC Final Rule"), pp. 16-31.

[47] SEC Final Rule, p. 17.

[48] SEC Final Rule, pp. 38-51.

Furthermore, under these amendments, an NRSRO must provide the SEC with an unaudited annual report of the number of credit rating actions (upgrades, downgrades, placements on credit watch and withdrawals) that occurred during the fiscal year in each class of rating for which the NRSRO is registered with the SEC.[49]

The amended rules also enhance disclosures that an NRSRO makes in Exhibit 1 and 2 of Form NRSRO in regards to ratings performance measurement statistics and ratings methodologies. Pursuant to these amendments, an NRSRO must:

- provide transition statistics for each asset class of credit ratings for which it is registered or is seeking registration, broken out over 1, 3 and 10 year periods; and
- enhance disclosure on (1) how much verification performed on underlying assets is relied on in determining ratings, (2) whether it considers, in determining its ratings, assessments of the quality of originators of the underlying assets, and (3) its surveillance process, including how changes to models are applied to existing ratings.[50]

In addition to adopting final rules, the SEC proposed or re-proposed additional measures related to transparency and competition concerning CRAs. The proposed amendments would:

- require NRSROs to publicly disclose ratings history information for 100% of their current issuer-paid credit ratings in an XBRL format; and
- prohibit an NRSRO from issuing a rating for a structured finance product paid for by the products issuer, sponsor or underwriter unless information about the product is made available to other NRSROs.[51]

[49] SEC Final Rule, p. 35.

[50] SEC Final Rule, pp. 7-16.

[51] *Re-proposed Rules for Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 34-59343 (February 2, 2009).

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