New European legislation on credit agencies

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One and a half years after the Commission's legislative proposal to reinforce the regulatory framework of credit rating agencies (CRAs), Europe remains expectant in the run up to the entry into force of a new regulatory package on 20 June 2013 that will aim to enforce a series of stricter rules of conduct and measures for CRAs. The new legislation, which consists of a Regulation and a Directive, tackles a number of issues that have lead to a misuse of credit ratings. Among others, the main issues addressed relate to an overreliance on credit rating by financial markets and investors, lack of transparency of the sovereign rating process and high market concentration in the credit rating market.

Tackling the excessive overreliance in CRAs

Ratings have gained a quasi-institutional role in European and national law and some investors rely disproportionately on external credit ratings. The new rules will reduce reliance on external ratings by compelling financial institutions to conduct their own risk assessments and providing investors, issuers and other interested parties with sufficient information and resources allowing them carry out such assessment.

A European Rating Platform should be established by the European Security and Markets Authority (ESMA) to facilitate information on credit quality and on the performance of the underlying assets of the structured finance instruments. CRA´s obligation to submit rating information will improve the comparability and visibility of all credit ratings that exist with regard to a specific rated entity, thus making it possible for investors and issuers to consider the whole variety of opinions before taking their own investment decision and reducing the existing over-reliance on CRAs. Furthermore, the new legislation amends the current directive on the activities and management of institutions of occupational retirement provisions (IORP), undertakings of collective investment in transferable securities (UCITIS), alternative investment funds managers (AIFM), credit institutions or investment firms among others, as an attempt to reduce their reliance on external ratings and to enhance an internal assessment of the creditworthiness of their assets.

Regarding European Supervisory Authorities, the new Regulation requires them to avoid references to credit ratings in their guidelines and recommendations where such references have the potential to create mechanistic effects or sole reliance on external ratings.

Towards more transparency

The new legislation seeks to overcome the current opacity in the management and operation of CRAs by increasing transparency of sovereign ratings. The latter is tackled by demanding more precision from CRAs, so that any sovereign ratings shall be issued in a manner which ensures that the individual specificity of a particular Member State has been analyzed. To avoid market disruption, ratings will be limited to three per year for unsolicited sovereign ratings and these will only be published on Fridays after the close of business hours of regulated markets and at least one hour before the opening of trading venues in the EU. Yet again, to increase transparency of sovereign ratings and facilitate understanding of credit ratings by investors and Member States, it is required for all credit rating agencies to provide a detailed research report explaining all the assumptions, parameters, limits and uncertainties and any other information taken into account in determining that sovereign rating or rating outlook and simultaneously they are expected to make that report publicly available, clear and easily comprehensible.

As of 20 June 2013, ratings will cease to be simple opinions and issuers and investors will be able to hold CRAs liable for damages caused in case they infringe intentionally or with gross negligence any of the infringements explicitly listed in the Regulation or any of the obligations imposed on them by the said Regulation. To do so, the issuer or investor claiming damages should present a detailed report indicating the alleged infringement and how it had an impact on the credit rating issued, which will then be assessed by the competent court. Regarding CRAs´ civil liability and matters not covered by the Regulation, the latter addresses the applicability of national law as determined by the relevant rules of private international law.

In order to guarantee the independence of CRAs and to avoid conflicts of interests due to relationships between their shareholders and the rated entities, the new legislation aims to reinforce the conditions of independence applying to CRAs and to increase the level of credibility of credit ratings issued under the issuer-pays model. CRAs will be required to reveal publicly if a shareholder with 5% or more of the capital of the concerned CRA holds 5% or more of a rated entity. Furthermore, a given CRA will be prohibited from rating when a shareholder of a CRA with 10% or more of the capital or voting rights also hold 10% or more of a rated entity. In addition, a shareholder with 5% or more of the capital or the voting rights in a CRA cannot hold 5% or more of the capital or the voting rights of another CRA, a measure that will ensure diversity and independence of credit ratings.

Long-lasting relationships between rated entities and CRAs can compromise the impartiality of the latter and again undermine independence of CRAs. Often, CRAs appointed and paid by a corporate issuer have an incentive to issue overly favourable ratings on its debt instrument for its own profit. To avoid such a practice, the new Regulation sets out a maximum duration of the contractual relationship between the rated entity and the CRA and requires a rotation mechanism to mitigate the risk of entering a dynamic whereby an issuer refrains from changing credit rating agency as this could raise concerns of investors regarding the issuer's creditworthiness (lock-in effect). Where a credit rating agency enters into a contract for the issuing of credit ratings on re-securitisations, it shall not issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years. Issuers are therefore obliged to change CRA periodically.

A highly concentrated market

The credit rating market has settled for an oligopolistic structure, known to be a highly concentrated market with important barriers of entry. In order to increase competition, the new rules seek to encourage the use of smaller CRAs. On that point, they require that where a credit rating agency enters into a contract for the issuing of credit ratings on re-securitisations, it shall not issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years. The rotation mechanism mentioned above should have a positive effect on this particular aspect as it can facilitate new market entries and offer existing credit rating agencies the opportunity to extend their business to new areas.

- **Regulation (EU) No 462/2013** of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

- **Directive 2013/14/EU** of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of over-reliance on credit ratings.