



Report of the CEPS-ECMI Joint Workshop on “The Reform of Credit Rating Agencies”

19 November 2008

Decision-makers around the world depend on credit ratings. Investors rely on them as guidance to make the best investment decisions possible. Issuers use them to signal the quality of the underlying securities. Financial institutions and their supervisors use the ratings to determine the riskiness of assets for regulatory purposes. Given their widespread use, the focus on ensuring the quality and independence of ratings is understandable. As the current crisis confirms, reliable ratings are a key component of a healthy global financial market. It also appears that the rating agencies have had some role in the ongoing crisis. However limited that role might have been, regulators around the world are rushing to put forth rules to improve the operations of the rating agencies.

The European Commission’s recent proposal for a regulation on credit rating agencies¹ is an attempt to ensure that such an enhancement takes place as quickly and as seamlessly as possible within the EU. On 19 November 2008, exactly one week after the publication of the proposed legislation, representatives from major credit ratings agencies, financial institutions, and international organisations gathered at the **Centre for Policy Studies (CEPS)** to discuss the proposal.

The morning discussions were moderated by **Karel Lannoo**, CEO, CEPS, and focused on the industry’s response to the proposed legislation. Panel discussants included **Maria Velentza** (DG Internal Market, European Commission), **Ian Bell** (S&P), **Nigel Phipps** (Moody’s), and **Richard Hunter** (Fitch).

Proposed Regulation

The first discussant, **Ms Velentza (DG internal Market)**, gave a short summary of the recent developments. The rating agencies have not been regulated by any legislation within the EU, even though a narrow set of provisions can be found in the Capital Requirements and the Market Abuse Directives.² As far as their EU operations are concerned, the agencies have only been subject to the International Organization of Securities Commission’s (IOSCO) voluntary codes of conduct. Although the Commission’s 2006 communication³ has affirmed that self-regulation was a sufficient

¹ SEC(2008) 2745-6.

² Directives 2006/48/EC and 2003/6/EC respectively.

³ 2006/C 59/2.

means for assuring the quality of ratings, the agencies' role in the financial turmoil convinced the Commission that formal regulation was needed.

Ms Velentza then presented the details of the legislation. According to the proposed regulation, market participants cannot “execute order on behalf of their clients” in securities rated by agencies not registered in the EU. Agencies can register by submitting an application to the home country authority. By being registered, the agencies are obliged to comply with a variety of rules, ranging from transparency requirements to governance principles for ensuring the quality of ratings and minimising conflicts of interest. Although the enforcement responsibility lies principally with the home country authorities, host countries can also act against an agency deemed to be in breach of its obligations.

In the rest of the morning session, participants and other commentators highlighted their concerns regarding the proposed regulation. The common themes that stood out from the discussions:

- 1 – Several participants questioned the form of the regulation and the legislative process;
- 2 – Industry representatives voiced concern that the regulation would imply major changes in the governance structures of agencies, some of which are unwarranted; and,
- 3 – Potential inconsistencies may arise if the regulation is implemented differently and if the treatment of the ratings of non-EU agencies is not clarified.

Overall form and process

In his opening comments, **Mr Lannoo** noted that the new law appeared to be too heavy-handed, far from the anticipated principles-based legislation. Maria Velentza responded that the detailed provisions were contained in the Annexes to the regulation, which could be adjusted through the use of the (Level II) Comitology procedures. In turn, the main text of the regulation contained the principles-based provisions, closely following the example of the Markets in Financial Instruments Directive (MiFID).⁴

Several participants also noted that the legislation appeared to be rushed, not only in terms of the speed with which it was formulated, but also in its implementation. Ms. Velentza noted that the “Better Regulation” disciplines were respected throughout the legislative process. In particular, the Commission asked for the opinion of Committee of European Securities Regulators (CESR) and European Securities Markets Expert Group (ESME), closely followed the US example set forth by the Credit Rating Agency Reform Act of 2006, launched public consultations with stakeholders and published an impact

⁴ Directive 2004/39/EC.

assessment. In terms of its the speed of implementation, Ms. Velentza also commented that the Member states will be allowed an adjustment period of six months, with the Level II measures possibly taking longer time.

Governance

The three discussants representing the three major rating agencies noted that the legislation would have ambiguous and possibly undesirable impact on the governance of the agencies. For example, Section A-2, Annex I requires that the board of directors include at least three independent and non-executive members. Among other responsibilities, these members are assigned with the task of monitoring the compliance of the internal systems and governance processes with the principles set out in the legislation. It was stated that it was not clear for the moment how the board could fulfill its obligations when the ratings are issued by a global team of analysts. **Nigel Phipps** (Moody's) remarked that the requirements appeared to impose an unprecedented "legislative governance" model on the agencies. Ms Velentza recognized that the agencies may have to change their governance structures and that further consideration would be given on these issues.

Another governance issue that received attention was the rotation requirement. According to Article 6(3) of the proposed legislation, analysts are not to provide rating services to the same entity (or related parties) for more than four years. Mr Phipps noted that these requirements would be hard to implement in smaller groups specializing in specific industries. Mr Phipps further noted that the requirement may mean that the group will have to be renewed every four years, which would be costly and the quality of the ratings may suffer.

The due diligence requirements for the information used by the agencies also attracted criticism. According to Article 7(2), the agencies have to ensure that the information they use are reliable and of sufficient quality. **Mr Hunter** questioned why the rating agencies were "put in a position to make up for the lack of transparency in the market as a whole." Similarly, Mr Phipps noted that the due diligence requirement would effectively turn agencies into "gatekeepers," responsible for the bad practices of other market participants. Ms Velentza responded by highlighting that the requirements were put forth to set minimal standards for publishing ratings.

Inconsistencies

Another major issue picked up by industry participants was whether the regulation would be implemented differently in different member states. As noted by several participants, home state authorities have interpretative powers in registration and enforcement measures, which could practically lead to 27 different implementations within the EU. The issue is complicated by the fact that the host state can also engage in punitive and legal measures by Article 22, which would reinforce the divergences. It was noted that although Article 20 prohibited competent authorities to interfere with the content of ratings, regulators could still tinker with the methodology of ratings. This would mean that different authorities could, in practice, require different methodologies, leading to

wide divergences in ratings within the EU. Nigel Phipps further noted that global inconsistencies could appear as other industrialized countries start changing their laws. Ms Velentza retorted that the Committee of European Securities Regulators (CESR) would have a coordination role to ensure that the technical details and the enforcement measures would be similar across the EU. She repeated the EU's commitment to cooperate with other countries.

Perhaps the most pressing concern that emerged during the discussions was whether ratings issued by unregulated agencies outside the EU could be used by financial institutions. Article 4 stipulates that investment firms and credit institutions in the EU should not "execute orders on behalf of their clients with respect to financial instruments" rated by agencies not registered in the EU. Ms Velentza remarked that this provision was put forward to ensure that only the ratings of registered agencies would be useable. As several participants noted, however, it is not clear who would be liable if such information is indeed used. In particular, the regulation contains no rules for punishing the non-compliant investment firm. Article 21, which lists the enforcement measures, is applicable only to credit rating agencies. Since the agency in question is not registered within the EU, the Community laws would have no jurisprudence to hold it accountable.

Several issues emerged at the end of the discussions. First, as remarked by several industry participants, the regulation contains ambiguities and inconsistencies that need clarifications and modifications. Second, as summarised by **Bertrand Huet** (SIFMA), the difficulty of complying with Article 4(2) of the regulation could lead to a move towards private ratings. Third, based on the shortcomings identified during the discussions, **Rym Ayadi** (CEPS) noted that the regulation would raise barriers of entry for rating agencies willing to enter the EU market. Lastly, a number of discussants have noted that in its present form, the law would only be applicable for the use of ratings in regulatory purposes, not the broad use foreseen by Article 2.

Afternoon session

In the afternoon, a panel discussion focused on the way ahead for the reform of credit rating agencies. The moderator **Rym Ayadi**, Senior Research Fellow, Centre for European Policy Studies (CEPS), structured the discussion around three issues: registration and oversight; conflicts of interest and transparency; and use of ratings. The participants in the panel were **Bertrand Huet**, Managing Director, European Legal and Regulatory Counsel, Securities Industry and Financial Markets Association (SIFMA), **Stéphane Janin**, Head of International Affairs Division, Association Française de la Gestion Financière (AFG), **Pierre Lepinoy**, Head of Portfolio & Risk Management, Securitisation, Fixed Income, BNP Paribas, and **Dieter Kerwer**, Assistant Professor, Technische Universität München.

Overall, despite finding some areas of concern, all of the four panellists welcomed the Commission's move to regulate the credit rating agencies (CRAs). As far as conflicts of interest are concerned, there was disagreement among the panellists on whether these are a theoretical rather than a practical issue. Also transparency was a controversial issue. On the one hand, it was argued that too much transparency could hamper competition and prevent new players from entering the market. On the other, disagreement arose on whether differentiating ratings for structured products would be a good idea. In regard to the use of ratings, there was broad agreement that ratings are unavoidable but this should not prevent financial actors to perform their own risk assessment.

Registration and oversight

Mr Huet considered the proposal as an improvement with respect to the previous consultation paper, and supported the use of the instrument of a Regulation rather than a Directive in order to achieve a consistent registration and oversight process in the EU. Moreover, he claimed that restoring confidence in rating agencies figures as a top priority in the securitisation market, as highlighted by a SIFMA Global Report on restoring confidence in the securitisation market to be published shortly. Hence, it was argued that regulating CRAs with the objective of restoring investor confidence is the right way to go. Mr Huet also welcomed that CESR would play a role as single European point of entry, simplifying the registration process, although the current provisions on cooperation with other EU Level 3 committees as well as with 3rd country regulators needed strengthening. He warned that the prohibition on EU firms from selling debt instruments to investors unless that debt is rated solely by an EU registered CRAs (Article 4(2)) would be not only hard to comply with but also inconsistent with the global nature of the ratings business. He further warned that the provisions allowing regulators to require CRAs to withdraw ratings would cause significant risks of fire sales by investors, acting against the restoration of liquidity and stability. Finally, while welcoming the improved consistency of the revised Proposal with the IOSCO Code, Mr Huet criticised it for being excessively intrusive in the governance structure of CRAs.

Mr Lepinoy warned that regulating CRAs would implicitly assume that ratings are a public good. However, he argued that assessing risk is a duty of the investor rather than of rating agencies, and that it is dangerous to rely solely on ratings. In effect, the ratings of structured products were good: it was the underlying assets that were of poor quality, Mr Lepinoy contended. For this reason, CRAs should be mandated to disclose the volatility of ratings, risk assessment and assumptions in methodologies. Mr Lepinoy also found Article 4 of the proposal to be problematic for preventing investors to buy some securities.

Mr Janin welcomed the Commission's proposal but added that it arrived too late. As early as July 2005, AFG had responded to the Commission "Financial Services Policy Green Paper" consultation by identifying CRAs as a top priority for action by the Commission – considering both that EU legislation was reinforcing the regulatory status of ratings themselves (e.g. CRD) and that there was already a huge development of structured products which was reinforcing the role of CRAs. In its main aspects, the draft

Directive on rating agencies is positive: better transparency on methodology parameters, adapted rating scale for structured products, and the avoidance/disclosure of conflicts of interest. However, he argued that governance requirements of the current version of the draft Directive seemed to go too far and that the legislation should not mandate ratings' methodologies due to competition concerns. Moreover, Mr Janin claimed the proposal should avoid restricting investments by asset managers only to securities which would be rated by an agency registered in the EU. He concluded by saying that because sovereign debt ratings are politically sensitive, CESR - as opposed to national regulators - should play a leading role in their registration and supervision.

Mr Kerwer pointed to the shift that had occurred in favour of regulating CRAs as being a departure from the consensus existing two years ago. In effect, before the present financial crisis, rating agencies were mostly seen as neutral information providers; now they are envisioned as quasi-regulatory entities. Moreover, he argued that even if ratings were not regulated, some sort of intervention would be warranted. CRAs have established a global network of ratings that "regulates" the market. Therefore market forces cannot police the CRAs themselves. Mr Kerwer continued by defending the European approach as an attempt to establish a code of best practice for credit rating agencies. He concluded by saying that the US approach relying on market discipline and transparency would not work.

Conflicts of interest and transparency

Mr Huet welcomed the provisions in the Proposal reinforcing transparency of CRA ratings and processes. He added however that this needed to be complemented by more disclosure and standardised reporting of underlying assets on the part of originators, which SIFMA and other associations are working on improving. Mr Huet found that placing a different symbol on structured products ratings would represent a stigma which could cause market disruption, and called instead for greater disclosure of assumptions and risks inherent in structured products. While acknowledging that the interaction between CRAs and originators in the case of structured products is much more prominent, Mr Huet argued that allowing the iterative process was essential. He concluded by supporting the Proposal requiring transparency of unsolicited ratings but that this benefit could be undermined by the requirement to subject unsolicited ratings to different symbols. Unsolicited ratings can be an important tool to further competition and can also act as a check on the conflict inherent in the "issuer pays" business model of CRAs.

Mr Lepinoy placed the burden of disclosure of information on underlying assets on originators rather than on rating agencies. Moreover, he warned against relying too much on ratings because they do not reflect certain types of risk and can be volatile. He concluded by adding that he found no evidence of conflicts of interest in credit rating agencies.

Mr Janin called for more transparency in methodologies used for ratings and for separated rating scales for structured products. Liquidity risk and risk in the underlying assets were not reflected in the ratings, Mr Janin claimed. Despite the fact that conflicts

of interest may not take place in practice, market confidence would be boosted by strong provisions against conflicts of interest. In particular, Mr Janin said that remuneration should be devised as to minimise conflicts of interest and he welcomes the proposal to disclose the 20 largest customers of each CRA.

Mr Kerwer said that too much disclosure may hamper competition because new entrants that devise innovative methodologies would be forced to disclose the element that put them at a competitive advantage. Mr Kerwer added that there is a serious conflict of interest in the case of structured products, insofar as CRAs lie at the centre of the manufacturing process of these financial instruments. He agreed that ratings for structured products should be different than corporate or sovereign ratings in which CRAs play more a role of external observers.

Use of ratings

Mr Lepinoy found a contradiction between reducing reliance on ratings and regulating the CRAs. However, he admitted that there is no real alternative to ratings. **Mr Janin** said that asset managers were required – in particular in France – to develop internal tools and to possess expertise before investing in complex products (e.g. “programmes d’activité”, i.e. programmes of operations, in France), but external ratings will always be used. In particular, CRAs play a vital role in reducing the asymmetry of information on financial markets: external ratings are supposed to bring additional information, as CRAs have a legal right to access to inside information from issuers. He also said that because of mounting complexity of financial products and the over-reliance on ratings was more of a market practice issue than a regulatory issue. The uses of ratings for regulatory purposes has reinforced their roles in recent years. However, the lack of transparency associated with structured products could not be solely solved by external ratings. It would also depend on the level of transparency given by the originators themselves (e.g. the justification of the implicit volatility value taken into account by issuers when they issue a structured product embedding options). **Mr Huet** added that due to the CRD’s drastic due diligence requirements on financial intermediaries, investors would be unlikely to return to the structured finance market, making the issue of over-reliance a moot one. **Mr Kerwer** claimed that ratings have a role to play in risk-sensitive regulation. Because market prices are volatile and internal risk management is problematic, there is no real alternative to ratings.

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