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Credit rating reformed

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The EU Commission recently proposed major changes to Regulation (EC) No 1060/2009 of September 16 2009 on credit rating agencies (Cra Regulation). The purpose of these changes was to reinforce competition between credit rating agencies (Cras); help avoid possible conflicts of interest under the issuer-pays model; enhance transparency and the quality of ratings; and promote the issuance of unsolicited ratings.

The proposed changes to the Cra Regulation also include an overhaul of the registration and supervision regimes for Cras. In addition to raising significant implementation issues for issuers and arranging banks, many market participants doubt that the proposed changes will assist in achieving their stated purpose.

Following in the footsteps of Rule 17g-5 of the Securities Exchange Act of 1934 in the US, the EU Commission's proposal requires issuers or related third parties (including arranging banks, sponsors, originators and servicers) (i) to provide to the ra appointed by them (hired Cra) and (ii) upon request, to make available to other Cras (non-hired Cras) meeting the criteria referred to below, "all information necessary for the credit rating agency to initially determine or monitor a credit rating of a structured finance instrument" on a password-protected website.

Non-hired Cras which are registered or certified (ie, non-EU Cras approved under the Cra Regulation) shall be given access to such information "without delay", provided that they (i) have the systems and organisational structure in place to ensure confidentiality of the information and (ii) provide ratings on a yearly basis for at least 10% of the structured finance instruments in respect of which they request access to such information. The conditions of access and terms of confidentiality applicable to the issuer's website will be specified by the EU Commission through implementing regulations.

In addition, each hired Cra is required to maintain a password-protected website which shall (i) contain a list of structured finance instruments for which it is in the process of rating, together with the relevant issuer's name and the type of instrument and (ii) provide a link to the relevant issuer's website so that non-hired Cras can access the relevant rating information. Hired Cras are also required to grant access without delay to such website to non-hired Cras, either registered or certified, upon request, subject to such non-hired Cra complying with the requirements referred to above.

Transparency

The scope of the information required to be included on the website to be maintained by the issuer or related third party is not clear. "All information necessary for the Cra to initially determine or monitor a credit rating of a structured finance instrument" is potentially very wide. In particular, the scope of the information to be provided is not limited to information provided to the Cra by the issuer or a related third party (unlike the position under Rule 17g-5 in the US).

Given its breadth, "necessary information" is likely to include details of the legal structure of the transaction and the characteristics of the underlying assets such as LTV, historical default data, legal features and economic performance. However, without any clear guidance on what constitutes "necessary information", it is

difficult to see where issuers are going to draw the line in determining what information must be included.

The information required to be included on the website is likely to include information provided orally to a hired Cra and its lawyers including discussions and negotiations with such Cra and its lawyers relating to the applicable transaction documents. This means that the process of information exchange between arrangers and hired Cras will likely become more formalised, including the written submission of information that may, in the past, have been provided orally. Arrangers will also need to implement procedures to ensure that all communications between hired Cras and arrangers (including their respective lawyers) are contemporaneously posted to the applicable website.

When implementing the proposed rules, the EU Commission should make clear what constitutes "necessary information" for rating purposes to avoid what might otherwise be an unduly onerous requirement for issuers and arranging banks. In doing so, consideration should be given to a materiality threshold and limiting the requirement to information that is actually provided to the Cra by the issuer or related third party.

Access to information

Issuers and arrangers will also be concerned with the conditions on which a non-hired Cra can access the information on the website maintained by them – particularly to the extent that "necessary information" extends to information that is sensitive and proprietary to such issuers and arrangers. It is intended that the EU Commission will adopt detailed rules specifying the conditions of access and the requirements of the website in order to ensure the accuracy and the confidentiality of data and the protection of personal data. Those proposed rules are yet to be published.

As is the case under Rule 17g-5 in the US, Cras are only responsible for providing non-hired Cras with access to the website maintained by the issuer or a related third party. Issuers and arrangers will be concerned about potential liability to non-hired Cras (and potentially investors relying on ratings provided by such non-hired Cras) in respect of the accuracy and completeness of information provided on its website and made available to such non-hired Cras.

Will they succeed?

One of the stated purposes of the proposed amendments is to enhance the quality of ratings. The rating mistakes made in respect of sub-prime and structured finance instruments were not necessarily caused by a lack of regulation, nor by the alleged misconduct by Cras in running their operations, but mainly because (by admission of certain Cras themselves) of rating assumptions which were incorrect.

It is the explicit intention of the Cra Regulation not to interfere with the substance of credit ratings. Indeed, the proposed amendments to the Cra Regulation provide that neither the European Securities and Markets Authority (Esma) – the new pan-European financial regulator yet to be established – nor the national regulators shall interfere with the content of credit ratings or methodologies.

This raises the question of whether regulating the conduct of the Cra business without supervising the merits and contents of the rating activity itself will prove to be adequate.

Another of the stated purposes of the proposed amendments is to promote the issuance of unsolicited ratings. Although an issuer may have satisfied the requirement to post to its website all information relevant to the hired Cra to determine its credit rating, the issuer may not have posted all information that is relevant to the non-hired Cra to determine its credit rating – each Cra has different criteria by which it assigns credit ratings. In such circumstances, it is difficult to see how the non-hired Cra would be able to assign an unsolicited rating (indeed, in such circumstances, the non-hired Cra may well be under a duty not to rate pursuant to other requirements of the Cra Regulation).

Conflicts of interest

Helping to avoid possible conflicts of interest under the issuer-pays model is also a stated purpose of the proposed changes. Whilst the policy behind more transparency seems clear in principle, it is difficult to see how the proposed changes will solve the conflicts of interest issue inherent in the issuer-pays model. Some market commentators are of the view that the issuer-pays model is intrinsically flawed as misaligned interests within a Cra exist in every rating: on the one hand, to rate the transaction and generate income for the Cra business and, on the other, to protect investors by potentially refusing to rate if a sound rating decision cannot be made. Close supervision and enhanced transparency may help in reducing conflicts of interest within Cras but will not make such conflicts disappear.

Esma's supervision

Significant changes have been proposed in respect of the allocation of powers between national regulators and Esma. Under the proposed new rules, Esma will be responsible for all aspects of the registration process (including examination of the application, approval and withdrawal of registration) and for day-to-day supervision of Cras. This centralised process is to be welcomed as it simplifies the current complicated model whereby these roles are split between national regulators and the Committee of European Securities Regulators (CESR).

In addition, Esma will have powers to (i) request information, conduct general investigations and on-site inspections with respect to Cras and related third parties; (ii) adopt supervisory measures almost identical to those previously given to the national regulators (including the right to suspend the use of ratings for regulatory capital purposes); and (iii) impose registration and supervisory fees proportionate to the "sizsize and economic strengthe and economic strength" of the relevant Cra.

The EU Commission is also given new enforcement powers including, at Esma's request, to impose fines on Cras (capped at 20% of annual income or turnover) and periodic penalty payments on Cras and certain related third parties (capped at 5% of the average daily turnover), in each case, where there has been a breach of the requirements of the Cra Regulation.

All decisions as to fines and penalties will be publicly disclosed by the EU Commission. The proposed streamlining and overhaul of the registration, supervision and enforcement procedures under the proposed changes to the Cra Regulation have been largely welcomed by market participants.

Other proposed changes to the Cra Regulation may impose unduly onerous and unquantifiable disclosure requirements for issuers and related third parties, including in relation to sensitive and proprietary information. They may raise uncertainties in relation to potential liability for issuers in respect of the information required to be disclosed and impose increased compliance costs relating to setting up and maintaining the websites required to be maintained by issuers and Cras.

In addition, many market participants doubt that the proposed changes will assist in achieving their stated purpose. If adopted in their current form, the new rules are expected to come into force during 2011.

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