

The New Regulation on Credit Rating Agencies is Published in the Official Journal of the European Union

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Introduction

The wait is over. The EU Regulation¹ (the "Regulation") on credit rating agencies ("CRAs") was published in the Official Journal of the European Union on November 17, 2009 and became effective, subject to certain exceptions, on December 7, 2009². The Regulation represents a fundamental change in the regulatory landscape for CRAs, banks and other market participants investing in rated products in Europe.

The main aspects of the Regulation include:

- registration requirements for CRAs established in Europe;
- an endorsement and certification regime for ratings which are issued by non-EU CRAs and used in Europe;
- restrictions on the use of ratings by banks and other financial institutions for regulatory capital purposes to ratings issued in compliance with the Regulation;
- strengthened supervision by THE Committee of European Securities Regulators (CESR) and the competent authorities of Member States over CRAs and their activities in Europe;
- organizational and operational requirements including independence, conflicts of interest rules, internal quality control and compliance systems for CRAs;
- detailed disclosure requirements as to rating analysis, methodologies, due diligence on underlying assets, models and key rating assumptions;
- a new rating regime for structured finance instruments; and
- continuing and periodic disclosure and transparency obligations for CRAs.

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Entry into Force

The following are the main transitional provisions set out in the Regulation:

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- subject as described below, the Regulation entered into force on December 7, 2009;
- the restriction on the use of ratings for regulatory capital purposes will enter into force on December 7, 2010;
- CRAs operating in the EU before June 7, 2010 (the "Existing CRAs"), which intend to apply for registration under the Regulation, shall (i) adopt all necessary measures to comply with the Regulation and (ii) submit their application for registration, in each case, by September 7, 2010; and
- Existing CRAs may continue issuing credit ratings which may be used for regulatory capital purposes unless their registration is refused.

Registration, Endorsement and Equivalence

The Regulation applies to credit ratings issued by CRAs registered in the EU and which are disclosed publicly or distributed by subscription. The Regulation does not apply to, inter alia, (i) private credit ratings produced pursuant to an individual order and which are not intended for public disclosure, and (ii) certain ratings issued by central banks.

Credit ratings to which the Regulation applies cannot be used for regulatory capital purposes by banks and other financial institutions in the EU unless:

- such ratings are issued by a CRA established in the EU and registered under the Regulation; or
- such ratings are issued by a CRA established outside the EU if such ratings are "endorsed" by a CRA established in the EU, registered under the Regulation and belonging to the same corporate group; or
- in respect of foreign issuers or instruments issued in third countries, such ratings are issued by a foreign CRA where the requirements of the "equivalence" regime are satisfied⁴.

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The endorsement regime contains stringent requirements including:

- adequate evidence that equivalent regulation and supervision are effective in the third country;
- the foreign CRA is authorised and registered in such third country; and
- cooperation arrangements are in effect between the EU and such third country⁵.

The equivalence regime also contains stringent requirements including:

- the foreign CRA is authorized or registered in the third country;
- the Commission has adopted an “equivalence” decision recognizing the “legal and regulatory framework of that third country as equivalent to the requirements of [the] Regulation”;
- cooperation arrangements are operational between the EU and such third country;
- the relevant credit ratings are not of “systemic importance to the financial stability or integrity of the financial markets of one or more Member States”; and
- such CRA is certified according to the Regulation (subject to exemptions available in certain circumstances).

Strengthened Supervision

CESR and the competent authorities of the Member States where CRAs are established will supervise the rating activities of CRAs in Europe. Although the EU regulators will not be involved with the substance of the rating process, extensive powers relating to registration requirements, withdrawal and suspension of registration, supervision and enforcement are given to CESR⁶ and the national authorities.

Independence and Avoidance of Conflicts of Interest

The Regulation imposes on CRAs duties of independence and avoidance of conflicts of interest including detailed organizational and operational requirements.

Organizational Requirements

CRAs have to ensure that:

- credit rating activities are independent, including from all political and economic influences or constraints;
- at least two independent directors are appointed whose remuneration cannot depend on the business performance of the CRA; and
- adequate on-going compliance policies and internal-control procedures are established.

Operational Requirements

CRAs are required to:

- identify, eliminate or manage and disclose, clearly and prominently, any actual or potential conflicts of interest;

- disclose the names of their largest clients (i.e. representing more than 5% of their annual revenue);
- maintain adequate records of their activities and conflicts;
- ensure that rating analysts and related third parties (including agents) do not invest in financial instruments issued by any rated entity within “their area of primary analytical responsibility”;

The Regulation does not prescribe specific penalties for breach. This is instead left to be determined by the Member States, raising the potential for disparities between penalties levied by different Member States.

- operate a gradual rotation mechanism for rating analysts and persons approving ratings; and
- ensure that rating analysts’ compensation is not linked to the revenue generated from the rating activity.

In addition, CRAs are prohibited from:

- rating if such CRA or its analysts, directly or indirectly, own financial instruments of the rated entity or a related third party (subject to limited exceptions);
- providing consultancy or advisory services to a rated entity or a related third party except for ancillary services⁷;
- making proposals or recommendations, either formally or informally, on the design of structured finance instruments⁸ which CRAs are expected to rate.

Transparency and Disclosure Requirements

The Regulation introduces a comprehensive transparency and disclosure regime for CRAs. The relevant requirements include disclosure of:

- methodologies, models and key rating assumptions (which must be based on historical experience including back-testing) used in credit rating activities and any material changes to any of these;
- the likely scope of credit ratings to be affected by any changes to rating methodologies, models or key rating assumptions;
- when departing from a rating previously issued by another CRA, an explanation of the reasons for their different assessment;
- conflicts of interest and compensation arrangements; and
- an annual transparency report setting out, inter alia, the relevant CRA’s legal structure and ownership, internal control mechanisms, record-keeping policy and compliance functions.

Structured Finance Investments

More stringent (and controversial⁹) obligations are imposed on CRAs in respect of the rating of structured finance instruments, such as:

- the use of rating categories that are “clearly differentiated using an additional symbol which distinguishes them from rating categories used for any other entities, financial instruments or financial obligations”;
- the disclosure of all information relating to the CRA’s loss and cash-flow analysis;
- the disclosure of the extent of due diligence carried out by the CRA on the underlying assets and the extent of their reliance (if any) on a third party assessment;
- the provision of guidance that explains assumptions, parameters, limits, and uncertainties surrounding the models and rating methodologies including simulations of stress scenarios, in a clear and comprehensible way; and
- the disclosure, on an ongoing basis, of information about all structured finance instruments submitted to CRAs for their initial review or for a preliminary rating, irrespective of the final rating.

A statutory duty “not to rate” or to withdraw an existing rating has been expressly provided by the Regulation where “the lack of reliable data or the complexity of the structure of a new type of financial instrument or the quality of information available is not satisfactory or raises serious questions as to whether a credit rating agency can provide a credible credit rating”. The effect and enforceability of such a duty is questionable.

Regulatory Inefficiencies

The registration process and supervision procedures are complicated, involving all Member States where a particular rating is used (deliberating through a college chaired by a facilitator) and, at a higher level, CESR. These requirements have been criticized as being likely to create unnecessary regulatory costs and inefficiencies, including:

- overly long registration or withdrawal discussions between the college and CESR;
- large numbers of Member States becoming members of the college, potentially affecting its smooth operations; and
- the potential interference between the regulators of different Member States if they take conflicting decisions or measures.

The Regulation does not prescribe specific penalties for breach. This is instead left to be determined by the Member States, raising the potential for disparities between penalties levied by different Member States. These issues raise the risk of regulatory arbitrage. In determining their jurisdiction of operations, CRAs are likely to take into account criteria including the sophistication and responsiveness of the Member State’s regulator, their ability to cooperate with other regulators within the EU and overseas and the penalties imposed by

the Member State’s regulator for breach of the Regulation.

Regulatory Powers and Due Process

The Regulation gives Member States and CESR far-reaching powers over CRAs and their activities in Europe. In particular, the authorities of the relevant home Member State and, in certain circumstances, the authorities of the other Member States where a rating is used, may, if it has been established that a breach of the Regulation by a CRA has occurred:

- withdraw such CRA’s registration;
- impose a temporary prohibition on such CRA issuing ratings; and
- impose a suspension on the use of its credit ratings for regulatory purposes throughout the EU or in the relevant Member State.

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Many of these powers conferred on the authorities of the Member States and CESR may be exercised where the relevant Member State has “established that a registered credit rating agency is in breach of the obligations arising from this Regulation”¹⁰ following notification to the facilitator and consultation with the members of the college but without, at present, a right of CRAs to object or be heard.

Impact

The impact that the Regulation will have on the credit rating business in Europe is potentially significant. Many aspects of the Regulation such as the rules on disclosure of rating information and the conflicts of interest rules may help to increase market efficiency and restore investor confidence. Other aspects of the Regulation such as the lack of due process, the procedural complexities and the perceived lack of global approach may increase regulatory inefficiencies and costs. It is the explicit intention of the Regulation not to interfere with the substance of credit ratings. This raises the question whether regulating the conduct of the credit rating business without supervising the merits and contents of the rating activity itself, will prove to be adequate. □

1. See Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies

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available at http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

2. The Regulation becomes effective twenty days after the date of its publication in the Official Journal of the European Union i.e. 17 November 2009 (see Article 41).

3. See Nick Shiren and Marco Crosignani, "Regulating Rating Agencies: Local Power, No Solution" IFLR, July / August 2009, 40.

4. See EU Commission, "Request for CESR technical advice on the equivalence between certain third country legal and supervisory frameworks and the EU Regulatory regime for credit rating agencies", 12 June 2009 available at http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

5. Ibid.

6. See CESR, "Guidance on Registration Process, Functioning of Colleges, Mediation Protocol, Information set out in Annex II, Information set for the application for Certification and for the assessment of CRAs systemic importance", 21 October 2009 available

at <http://www.cesr-eu.org/popup2.php?id=6142>.

7. Ancillary services comprise "market forecasts, estimates of economic trends, pricing analysis and other general data analysis as well as related distribution services" (Annex I, Section B, Item 4).

8. A "structured finance instrument" is defined in Article 3(l) as "a financial instrument or other asset[s] resulting from a securitisation transaction or scheme referred to in Article 4(36) of Directive 2006/48/EC"; "securitisation" is defined as "a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme" (Article 4(36) of Directive 2006/48/EC).

9. See Nick Shiren and Marco Crosignani, "The New Rating Regime for Structured Finance Investments in Europe", *The Journal of Structured Finance*, Fall 2009, 52.

10. See Articles 24 and 25.