

Brussels, 12 November 2008

## Credit Rating Agencies : Frequently asked questions

(see [IP/08/1684](#))

This document has been prepared by the Commission services (DG Internal Market and Services).

It is split into two parts: the first covers questions of a general nature; the second answers specific questions about how the proposed Regulation will work in practice.

Since the proposed Regulation has been submitted to the Council and the European Parliament for further legislating in the co-decision procedure, the answers to these questions cannot be regarded as definitive.

Furthermore, the information which is provided here is:

- of a general nature only and is not intended to address the specific circumstances of any particular individual or entity;
- is not necessarily complete and does not systematically cover all the aspects;
- is made available for general information only and does not constitute professional or legal advice;
- in no way constitutes an interpretative document.

It does not prejudice the position that the Commission might decide to take on the same matters if developments, including Court rulings, were to lead it to revise some of the views expressed here.

Nor does it prejudice the interpretation that the Court of Justice of the European Communities might place on the matters at issue.

### **PART I: General questions**

#### **1. What is a credit rating agency?**

Credit rating agencies provide independent opinions on what is the probability that companies, governments and a wide range of financial instruments will not repay their debt. The debt usually takes the form of financial instruments, like bonds, which borrowers (issuers) offer to investors. Investors, mainly banks and insurance companies, buy these instruments and are entitled to interest payments and ultimately a repayment of the debt by the borrower/issuer. The role of credit rating agencies is to look at a specific issuer or its instrument and to evaluate the likelihood that it will not be able to pay interest or the debt itself.

The conclusion of this assessment is summarised in a mark, or rating attributed to an issuer or its instrument (e.g. AAA for the lowest risk). Opinions of credit rating agencies, which often have greater experience and analytical capacity than investors, have a big impact on the availability and cost of credit for borrowers/issuers.

## **2. Why does the European Commission propose a regulation?**

The European Commission started to work on this proposal in the summer of 2007 when it first became clear that there were some signs of underperformance by the credit rating agencies. The proposal also responds to the commitments of Member States' Finance Ministers made at their meeting of 7 October to address the financial crisis that started in the US in 2007 and later expanded into the EU. It is also in line with the European Council conclusions of March and October 2008 where EU leaders called for a legislative proposal to strengthen the rules on credit rating agencies and their supervision at European level.

The proposal is one in a series of measures that are being undertaken at the EU level to deal with the problems revealed by the current financial crisis. With this initiative, the EU wants to ensure that the ratings to be used in the Community are independent, objective and of the highest quality. A common framework of rules in this area is most appropriate applying evenly in all Member States, as it will strengthen the good functioning of the internal market in financial services and afford the same levels of investor and consumer protection across the Community.

## **3. How did the CRAs contribute to the financial crisis?**

Credit rating agencies failed to sufficiently consider the risks inherent in more complicated financial instruments (notably, structured finance products, which are custom-made financial instruments that offer superior interest in comparison to traditional instruments and may be founded on risky assets, like US subprime mortgages). As a consequence, they manifestly underestimated the risk that those instruments may not pay interest or the debt itself. As they gave the highest possible grades (ratings) to many of those innovative instruments, investors felt encouraged to purchase them, without assessing properly the risks involved. Finally, as market conditions were worsening, credit rating agencies failed to reflect this promptly in their ratings. This failure by CRAs to produce sound and accurate ratings was combined with an imprudent and non-judicious approach of the investors, who relied blindly on credit ratings. As a result, credit was granted even if it was not justified by economic fundamentals. This market failure greatly contributed to the current financial crisis.

## **4. Why did the CRAs perform so badly?**

It is now broadly agreed that the following elements jointly led to poor performance of the CRAs:

- **Questionable practices regarding conflicts of interest:** Credit rating agencies need to work closely with the issuers of rated instruments to collect necessary information and because they are usually also paid by them, there is substantial risk that they may compromise on their independence and objectivity. Moreover, CRA staff preparing the ratings may be subject to inappropriate incentives that may affect the soundness of their judgement (e.g. they are involved in negotiating fee from issuer they will later rate).
- **Quality of ratings compromised by profit-seeking:** CRAs have not paid sufficient attention to ensuring sufficient staff numbers and their preparedness for the duties involved. They have focused on attracting new engagements from issuers rather than ensuring sound quality and accuracy of their ratings. The methodologies and data they have used to issue ratings have not been properly verified.

- **Insufficient transparency:** CRAs have been insufficiently transparent about how they develop their ratings (the processes they use, methodologies etc.) and how successful they are in their forecasts. They have used the same symbols to give ratings on instruments that are different in terms of the risks involved.
- **Lack of supervision:** Despite their major impact on the financial markets, CRAs have not been subject in Europe to formal control and surveillance by public authorities. A few of them have complied, at their own discretion, with a non-binding set of standards set by an international body – IOSCO (International Organisation of Securities Commissions).

## **5. Has the Commission respected 'Better regulation' disciplines when tabling this Proposal?**

This proposal is the result of long analysis and extensive public debate on the role of the rating agencies. In the summer of last year, the Commission publicly requested the advice of both the Committee of European Securities Regulators (CESR), which delivered on 13 May and the European Securities Markets Expert Group, which reported on 4 June. The Commission services have followed closely the work carried out by both the supervisors and the market experts and have benefited from the public consultation carried out by CESR in March of this year. The Commission has analysed these reports and has followed the developments in the US and other international fora, notably the International Organisation of Securities Commissions and the Financial Stability Forum. The Commission services have had in addition extensive discussions with stakeholders, both rating agencies and other industry participants. In August 2008 the Commission launched a public consultation on an earlier draft of the proposal. The Commission proposal is put forward with a comprehensive Impact Assessment.

## **6. Is regulation more appropriate as a legislative instrument?**

A uniform approach is necessary in order to create a framework where Member States' competent authorities can ensure that credit rating agencies apply the new set of requirements consistently across the Community. Currently, none of the Member States has a comprehensive registration and surveillance regime for the issuance of credit ratings. Therefore, a regulation is the most suitable instrument to ensure this consistent and uniform approach throughout the European Union because of its direct effect. A directive, which leaves the Member States a degree of flexibility in deciding how to adapt their national laws to the new framework, would not be efficient.

## **7. How will the Proposal ensure that CRAs based in 3<sup>rd</sup> countries comply with the new requirements?**

Credit rating agencies based in 3<sup>rd</sup> countries will be required to have a legal presence in the EU in the form of a subsidiary. This subsidiary will need to apply for registration in the Member State where its registered office is located. It will be expected to comply with all requirements under the proposed Regulation.

## **8. Wouldn't self-regulation be more appropriate to address the identified problems?**

Firstly, there is some recent experience with a self-regulatory approach to the CRA industry. In particular, the International Organisation of Securities Commissions (IOSCO), an international non mandatory standard setting organisation composed of securities markets supervisors developed in 2004 its *Code of Conduct Fundamentals for Credit Rating Agencies*. This code, which is currently followed by most leading CRAs on a voluntary basis, has failed as a self-regulatory framework. There are a few reasons for that:

- It is **based on "comply or explain" principle** – CRAs are free not to respect certain obligations stemming from the Code, as long as they disclose this fact.
- There is **no robust mechanism of control of the CRAs' activity**. In the EU, annual monitoring reports produced by CESR were only based on what the agencies agreed to disclose on a voluntary basis.
- Finally, **many substantive provisions of the Code simply lack strength** or are too lenient to ensure achieving their objectives (as confirmed by the CESR advice).

This does not mean that the IOSCO Code itself or its recent reforms are not useful – in fact, certain rules of the IOSCO Code have served as the baseline and inspiration for many provisions of the proposed Regulation. However, we have gone beyond these standards in those areas where we felt that more exacting measures would be appropriate. Also, this regulation unlike the IOSCO code is legally binding for CRAs.

## **9. How will the supervision of CRAs be organised?**

The proposed supervisory structure takes due account of the specificities of the rating activity and genuinely cross-border nature of the ratings. Firstly, CRAs will be subject to surveillance of the securities supervisors that already oversee EU's financial markets at national level. Secondly, it is based on the concept of the home Member State control, which has proven successful in other pieces of EU financial legislation. In practical terms this means that the securities supervisor of the Member State where the CRA is established shall be primarily responsible for day-to-day supervision. Thirdly, mechanisms that trigger closer co-operation between Member States regulators are envisaged. The home Member State supervisor would be required to inform and consult authorities in other Member States and to involve them in carrying out supervision and if necessary also enforcement of the rules on CRAs.

Supervisors from other Member States will have the possibility to co-operate in the supervision and will be empowered to take individual action against CRAs in their territory in exceptional cases. Finally, CESR is expected to assume a greater role in the co-ordination of the supervisory activities and practices at EU level, through a mediation mechanism and advice to the national authorities.

## **10. What will be the role of the Committee of European Securities Regulators (CESR) under this framework?**

The responsibilities of CESR will be important. First of all, CESR will serve as the entry point for any requests for registration from interested CRAs. It will also be the forum in which significant draft decisions of the home Member State supervisors will be discussed and endorsed at EU level. It will issue guidance on a number of subjects important for the proper functioning of the regulatory framework. It will also maintain a database with historical performance statistics of registered CRAs. Finally, CESR will be expected to engage in closer co-operation with its sister committees – Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

## **PART II: SPECIFIC QUESTIONS**

### **1. Will all CRAs be required to register?**

CRAs that would like to ensure that their ratings may be used by credit institutions, investments firms, insurance and assurance undertakings, undertakings for collective investment in transferable securities (UCITS) and institutions for occupational retirement within the Community will be required to register.

### **2. Will supervisors verify ratings?**

No. Supervisors will oversee the compliance of a CRA with its duties in terms of internal organisation, operational arrangements, human resources policies, presentation of ratings and disclosure. They will not interfere in the content of the ratings. CRAs will be solely responsible for the methodologies, model and rating assumptions they use and the opinions they develop on that basis.

### **3. Will CRAs become more open about how they develop their ratings?**

Yes. The proposed Regulation requires CRAs to disclose to the public the methodologies, models and key rating assumptions they use in the rating process. They will need to indicate the version(s) of methodologies/models used to produce a specific rating, and disclose any necessary adjustments made.

### **4. What safeguards are proposed to ensure that ratings developed are more sound and accurate?**

Firstly, CRAs are required to ensure that they systematically use all data available to them and which they have declared important to their rating. They should also have measures to establish whether the information used is of sufficient quality and from reliable sources. In particular, with regard to structured finance instruments they should state to what extent it has verified itself or relied on 3<sup>rd</sup> party assessment of due diligence processes at the level of underlying assets. CRAs will not be allowed to rate instruments in cases where they do not have sufficient quality information to do so.

Secondly, while the proposed Regulation does not stipulate how the rating methodologies should be structured and reviewed, it does require that they are subject to independent internal scrutiny. This scrutiny is to be performed by a dedicated review function within the CRA but separate from the business lines, which are responsible for the rating activity. This function will have a direct reporting line to the independent members of the administrative or supervisory board.

#### **5. What is notching? Why should it be dealt with?**

Notching refers to the practice whereby one rating agency reduces the ratings from another rating agency on structured finance collateral it has not rated itself. It may be a negative practice, if a CRA uses it predominantly to discourage the clients from relying on services of its competitors. But there may also be legitimate reasons for such downgrades (e.g. limitations of analysis in the competitor's rating).

The proposed Regulation prohibits CRAs to refuse a rating, because the rating they would need to use in their assessment on has been produced by another CRA. Additionally, CRAs will need to record all instances when they downgrade competitors' ratings in their analytical process, including a justification for such a downgrade.

#### **6. How will methodology changes impact existing ratings?**

When a credit rating agency changes its methodologies, models or key rating assumptions it will be obliged to immediately disclose the likely scope of credit ratings to be affected. It will also need to review the affected credit ratings as soon as possible and not later than within 6 months after the change, and in the meantime place those ratings under observation. If necessary, it will change the rating that was attributed earlier.

#### **7. Will ratings for structured finance be differentiated?**

Yes. CRAs will need to either differentiate rating categories for structured finance instruments, so that they are not confused with rating categories for other types of rated entities or financial instruments, or produce a comprehensive report attached to each structured finance rating. Such report would provide a detailed description of the rating methodology used to determine the credit rating and an explanation of how it differs from the determination of ratings for any other type of rated entity or financial instrument, and how the credit risk characteristics associated with a structured finance instrument differ from the risks related to any other type of rated entity or financial instrument.

#### **8. What will be the treatment of unsolicited ratings?**

Under the "issuer-pays model", which is currently followed by most leading CRAs, it is the issuer (or a third party acting on its behalf) that solicits the rating from a credit rating agency. The issuer then collaborates closely with the CRA's analysts providing them with the necessary information to develop a sound rating opinion. Finally, it is also the issuer that pays for the issuance of the rating.

Some CRAs also issue unsolicited ratings: they do not wait for the issuer to request a rating but they develop one on the basis of publicly available information. Such practice helps smaller CRAs increase their market share, but it also comes at a cost: the ratings produced may be based on less comprehensive information than in the case of ratings where the issuer was fully involved.

The proposed Regulation envisages that a CRA has to disclose its overall policy on unsolicited ratings. In addition, a CRA shall prominently disclose that the issuer did not participate in the rating process and that the CRA did not have access to its internal documents. Finally, unsolicited ratings will have a different rating category.

### **9. Does the proposal standardise the elements of a credit rating opinion?**

The proposed Regulation introduces rules on the presentation of credit ratings. These rules refer only to specific elements of a rating opinion and do not aim to create a single format for its presentation. As proposed, users of ratings may expect to find in a rating opinion the following elements at least:

- name and job title of the lead analyst,
- indication of material sources for the rating opinion,
- information, whether draft rating was disclosed to the issuer and changed following dialogue with the issuer,
- information on methodologies used,
- explanation of risks involved, sensitivity analysis of the assumptions made, worst-case and best-case scenario ratings,
- date of issue and last update of the rating,
- any limitations of the rating,
- extent to which information provided by the issuer and used in the rating process was verified.

### **10. As a user of ratings, how will I benefit from increased CRAs' transparency?**

Firstly, the CRAs will be required to provide more information regarding the rating process both in general and with respect to a specific issuer / financial instrument. Users will be able to consult CRAs' methodologies, models and key rating assumptions. They will be better informed of what information has been used in the rating process, what analyses have been undertaken and what general and specific limitations of the rating they should consider when developing the views on the creditworthiness of the rated entity. Users will also benefit from better and more comparable information on CRAs' historical performance.

Secondly, CRAs will be required to disclose to the public how they operate internally and how they address certain key challenges in their activity: relations with clients, conflicts of interest, ancillary services, communication policy (including the disclosure of ratings) and analytical staff issues (remuneration, staff adequacy). These on-going disclosures will be underpinned by an annual transparency report, which will reflect any findings and developments in the listed areas. Public availability of this information will exert discipline on the CRAs to improve their performance in qualitative terms.

## **11. What is the central repository?**

The central repository will be established by CESR with data provided by individual CRAs. It will be accessible to the public free of charge.

It will gather historical performance data of all registered CRAs, supplemented with information about their past rating activities. In particular, the data should inform how often defaults on payments take place in each of the rating category in the different asset classes rated by the CRAs (historical default rates). The statistics should also provide comprehensive information on 'rating migration', i.e. movements between rating categories.

As users of ratings will be better informed about the rating agencies' comparative performance they will be able to decide for themselves how much trust they can put in the ratings of a particular CRA. CRAs will come under closer market scrutiny and will need to pay due attention to quality of the ratings not to stay behind their competitors.

## **12. Will CRAs have to verify the information they receive?**

CRAs are not explicitly required to verify the information they receive to use in the ratings. They are however expected to take all necessary measures so that information they use in assigning a credit rating is of sufficient quality and from reliable sources. To reinforce this duty, CRAs are also required to inform in the rating opinion whether they consider satisfactory the quality of information available on the rated entity and to what extent they or a third party have verified the information they had received. If they do not have sufficient good quality information CRAs will be obliged to refrain from issuing a rating.

## **13. How will the proposal address the concerns related to conflicts of interest of CRAs?**

CRAs will have to improve the way they deal with conflicts of interest in order to regain markets' confidence. To ensure the independence of ratings, CRAs will be required to prevent conflicts of interest and/or to manage these conflicts adequately where they are unavoidable. They will have to disclose conflicts of interest in a complete, timely, clear, concise, specific and prominent manner and record all significant threats to the rating agency's independence or that of its employees involved in the credit rating process, together with the safeguards applied to mitigate those threats. CRAs will have to implement adequate internal policies and procedures to insulate employees involved in credit rating from conflicts of interest and ensure the quality, integrity and thoroughness of the rating and review process at all times.

## **14. Will the obligation to prevent conflict of interest have any impact on CRAs organisation?**

CRAs will have to reform their internal governance structure, introducing sound internal controls and sound reporting lines, clearly separating the rating function from business incentives. Therefore, first, CRAs will have to establish organisational and administrative arrangements to identify, prevent and manage conflicts of interest.

Second, the administrative or supervisory board of the CRAs will be responsible for ensuring that conflicts of interest are properly identified, managed and disclosed. Each CRA will have to have at least three independent directors within this board whose principal task will be to strengthen the internal discipline. These directors will have the specific task of monitoring the development of the credit rating policy, the effectiveness of the internal quality control system of the credit rating agency on the credit rating process to ensure that there are no conflicts of interest and the compliance and governance processes. Opinions of the independent directors issued on these matters will be presented to the board periodically and made available to the competent authority, whenever the latter requests it. Independent directors' remuneration cannot depend on the business performance of the rating agency. They will be appointed for a single term of office which can be no longer than five years. They can only be dismissed in case of professional misconduct. At least one of them should be an expert in securitization and structured finance.

### **15. What are the prohibitions and limitations that CRAs will have to respect in order to avoid conflicts of interest?**

In addition to following the general principle to avoid and/or manage and disclose conflicts of interest CRAs will have to respect the following rules:

- a CRA will have to disclose to the public the names of the rated entities from which it receives more than 5 % of its annual revenue,
- a CRA will not be able to issue a credit rating or will have to withdraw an existing credit rating when itself or its analyst involved in the credit rating have ownership of financial instruments in the rated entity or control links,
- a CRA will not be allowed to provide consultancy or advisory services to the rated entity or any related third party regarding the corporate or legal structure, assets, liabilities or activities,
- a CRA will only be entitled to provide ancillary services in case they do not present conflicts of interest with its rating activity,
- analysts will not be allowed to make proposals or recommendations, either formally or informally, regarding the design of structured finance instruments on which the CRA is expected to issue a rating.

### **16. Could the independence of the rating process be impaired by the commercial interest of the agency?**

There are two major models under which CRAs currently operate. In the so-called "issuer-pays model", it is the issuer who solicits and pays for the rating. In a "subscription- or investor-pays model", those paying for the CRAs' opinions are existing or potential investors in the rated entity. Either model gives rise to specific conflicts of interest, since eventually the CRA is paid by someone that has an interest in the rated entity.

The proposed Regulation aims to ensure that the legitimate business interests of the rating agency are not affecting the independence of the rating process. The proposal puts forward different measures to deal with this issue. First, the independent members of the board will monitor the effectiveness of the internal quality control system of the agency on the credit rating process to ensure that there are no conflicts of interest.

Second, the compensation arrangements of employees involved in the rating process will not be contingent on the amount of revenue that the credit rating agency derives from the rated entities or related third parties to which the analyst or persons approving the credit ratings provide services; compensation arrangements will have to be determined primarily by the quality, accuracy, thoroughness and integrity of their work. Similarly, the remuneration of the independent members of the board will not be linked to the business performance of the agency and will be arranged so as to ensure the independence of their judgement. Third, the agency will have to design its reporting and communication channels so as to ensure independence of analysts and persons approving the credit ratings from the other parts of the agency representing the commercial interests of the credit rating entity. And fourth, employees who are directly involved in the credit rating process will not be allowed to initiate or participate in negotiations regarding fees or payments with any rated entity.