Opinion of the European Economic and Social Committee on the 'Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers in respect of the excessive reliance on credit ratings'

COM(2011) 746 final — 2011/0360 (COD)

(2012/C 229/12)

Rapporteur: **Jörg Freiherr FRANK VON FÜRSTENWERTH**

On 9 February 2012 the Council decided to consult the European Economic and Social Committee, under Article 53(1) of the Treaty on the Functioning of the European Union, on the

Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings

COM(2011) 746 final — 2011/0360 (COD)

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 8 May 2012.

At its 481st plenary session, held on 23 and 24 May 2012 (meeting of 23 May), the European Economic and Social Committee adopted the following opinion with 130 votes in favour and four abstentions.

1. Conclusions and recommendations

1.1 This opinion follows on from the EESC's work on the regulation of rating agencies as part of efforts to address the crises of the last few years [1]. The Committee has very recently welcomed the Commission's efforts, through the development of new legal instruments, to rectify major shortcomings in the domains of transparency, independence, conflict of interest, and the quality of procedures and rating methods [2]. At the same time, it expressed disappointment that the response to the inadequate regulation of rating agencies has been so tardy and has not gone far enough.

1.2 The proposed directive formally amends the UCITS (Undertakings for Collective Investment in Transferable Securities) Directive and the AIF (Alternative Investment Funds) Directive. The main thrust of the regulation concerns changes to risk management, which are to limit or prevent external ratings being taken on automatically as a matter of course, without being checked. These rules are to be accompanied by a change to the CRA (credit rating agencies) Regulation, on which the EESC has already issued an opinion [3]. The content of the two legislative proposals is closely related.

1.3 The Committee welcomes the fact that the proposal tackles the problem of market participants' over-reliance on ratings for UCITS and AIF and attempts to prevent a herd mentality being triggered amongst financial players by inadequate ratings. These efforts must include the whole body of EU law, national laws and private-law contracts.

1.4 The Committee deems the regulation's approach to specifying provisions for the risk management of UCITS and AIF to be the right one. It points out the problems that small financial institutes could have in building up their own capabilities for risk analysis. It therefore suggests that the legislative instruments – delegated acts – contain rules and regulations on cooperation on the development of external specialist knowledge in order to make small financial institutions less dependent on external rating agencies. The Committee strongly opposes calls for SMEs to be able to outsource the decision on the creditworthiness of an investment.

1.5 The Committee considers that more efforts need to be made to develop procedures and yardsticks in risk management processes, which can be used as an alternative to ratings.

1.6 It would highlight the need for a joint approach to be adopted at G 20 level. The inadequacy of regulations worldwide in this domain can only be solved if there is a minimum of consistency between national legislation on the subject.

1.7 The Committee would reiterate the scepticism it already expressed in its opinion of 12 March 2012 on rating agencies [4], to the effect that not even market participants' own risk assessment and less reliance on external rating

[1] See OJ C 277, 17.11.2009, p. 117 and OJ C 54, 19.2.2011, p. 37.
[2] OJ C 181, 21.6.2012, p. 68 on the *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies* COM(2010) 747 final – 2011/0361 (COD).
[3] See footnote 2.
[4] See footnote 2.

agencies guarantees objectivity in the decisions made by financial market participants or the inclusion of all decisive aspects – in relation to the consequences of the assessment. Furthermore, it believes that one of the fundamental problems of risk assessment lies in the credibility (and independence) of the ratings issued by rating agencies, which have over the last few years repeatedly proven to be wrong or excessively influenced by the interests, ways of thinking and structures particular to domestic markets outside Europe or by the interests of the financial issuing bodies who finance them. Against this background, the Committee urges that it be constantly borne in mind in the further discussion of the regulation of rating agencies that up to the most recent times these agencies have repeatedly, directly or indirectly, caused long-term damage to all sectors of society. The Committee therefore regrets that efforts to set up an independent European rating agency have not yet met with success.

2. **Proposal summary and context**

2.1 The proposal is part of the measures for monitoring rating agencies to be taken in response to the initial banking crisis which developed into a financial, then a sovereign debt, crisis. Since 7 December 2010, the day when the CRA regulation came fully into force, rating agencies have been bound to keep to certain rules of conduct, which keep conflicts of interest in check and ensure high quality and a certain amount of transparency in ratings and the ratings process. On 11 May 2011, the CRA regulation was amended [5] to give the European Securities and Markets Authority (ESMA) exclusive supervisory powers over rating agencies registered in the EU.

2.2 The CRA regulation and the May 2011 amendment thereof did not, however solve one problem that was partly responsible for the crises, namely the risk that financial market participants, especially UCITS (Undertakings for Collective Investment in Transferable Securities) and AIF (Alternative Investment Funds), rely overly and automatically on (external) ratings in their risk management systems, and in so doing undertake no risk assessments or due diligence checks of their own. Financial players can be tempted to do so on the basis of cost and simplification considerations. The danger for the public at large, however, resides in the fact that this can create a herd mentality amongst market players [6]. When responses are automated and guided by the same ratings, whenever an investment grade is lost it can lead precisely to a parallel selling-off of debt instruments, potentially endangering financial stability. Pro-cyclicality and 'cliff effects' (a rating downgrade of a security below a given threshold, triggering the selling-off of other securities in a chain reaction) likewise describe the risk. There have been repeated references [7] to the urgent need to reduce these risks.

2.3 The proposal in hand tackles the problem of market players' excessive reliance on ratings for UCITS and AIF. Other proposals deal with a solution to this same problem for credit institutions, insurance companies and investment firms in a financial conglomerate [8]. The provisions on risk management for UCITS and AIF are laid down in Articles 1 and 2, stipulating that companies may not rely solely or automatically on external ratings. This complements the existing supervisory rules, under which financial players have to use risk management systems which allow them at any time to monitor and measure the risk associated with their investment positions and their contribution to the overall risk profile of their portfolio. At the same time, the Commission's powers are being expanded so it can lay down criteria for assessing the suitability of risk management systems through delegated acts, also to prevent excessive reliance on external ratings.

2.4 The proposal should be seen in conjunction with the proposal presented on the same day, entitled 'Proposal for a Regulation of the European Parliament and of the Council amending Regulation No 1060/2009 (EC) on credit rating agencies' [9]. In that proposal, alongside other points, additional proposals are made with a view to preventing market players relying overly on ratings, while rating agencies are obliged to make comprehensive information available to financial players. This includes information about rating methods, their underlying assumptions and types of rating. On the other hand, issuers of structured financial instruments should make more information available to the market on their products (credit quality, performance of underlying investments, securitisation structure, backed cash flows, etc.). Taken together, the aim of the amendments to the CRA regulation is to make it easier for players to make their own assessment of the credit quality of a financial instrument. Neither proposal can therefore be viewed in isolation from the other.

3. **General comments**

3.1 The Commission proposal deals with one particular aspect of the inadequate regulation of rating agencies, namely the impact of ratings on the action of financial market players and the consequences thereof for the markets. The proposal is the result of an analysis of the causes of the crises of the last few years. Rating agencies' actions have also contributed to this situation. They issue forecasts about creditors' payment possibilities and willingness to pay, be they private creditors or states. They have a decisive influence on world financial markets, since many financial players (UCITS, AIF, credit institutions and insurance companies) refer to ratings when making investment decisions. The Committee has in the last few years - most

[5] OJ L 145, 31 May 2011, p 30.

[6] Cf. The Financial Cycle, Factors of Amplification and possible Implications for Financial and Monetary Authorities, Banque de France, Bulletin No 95, November 2001, p. 68.

[7] COM (2010) 301 fin; European Commission consultation paper on reworking the Credit Rating Agencies (CRAs) regulation, http://ec.europa.eu/internal_market/consultations/2010/cra_en.htm; Council conclusions of 23 October 2011; Principles for Reducing Reliance on CRA Ratings.

[8] COM(2011) 453 final.

[9] COM (2011)747 final – 2011/0361 (COD).

recently in its opinion of 12 March 2012 [10] specifically on the subject – repeatedly highlighted shortcomings in the regulation of rating agencies, and in so doing has adopted clear stances on the matter, which are also at the root of this opinion and to which it would refer here.

3.2 Most recently, the crises of the last few years have first of all made it clear that incorrect rating assessments have a considerable and damaging effect on the broader economy, and even on whole states and society in general. They have also demonstrated, however, that markets have not been in a position to prevent excesses. There is therefore a need for strict, consistent state regulation of rating agencies. Here, in view of the global G20 context, EU-level regulation must be supported, with the aim of securing a minimum degree of consistency in the rules worldwide. It is absolutely vital [11] that, when ratings are drawn up, a minimum standard is adhered to, whereby the principles of integrity, transparency, responsibility and good corporate management are guaranteed and remain so.

3.3 The Committee confirms that in the last few years, significant – albeit very belated – progress has been made in regulating rating agencies. If from now on, thanks to the proposal of 15 November 2011 to amend the CRA regulation [12], problem areas such as 'rating outlooks', 'CRA independence', 'disclosure of information', 'sovereign ratings', 'comparability of credit ratings', a 'rotation mechanism' for credit rating agencies, 'civil liability' and 'use of external ratings' are tackled in regulatory provisions on rating agencies, this is to be welcomed. The EESC has adopted a stance on this [13] and given concrete pointers. It is disappointing, however, that the problems of the market dominance of the major rating agencies and alternative payment models have not been sufficiently discussed.

3.4 The proposal now addresses, through accompanying measures, for UCITS and AIF also, the problem of automatic, unthinking acceptance of external ratings which can – as pointed out in the proposal - lead to a herd mentality developing amongst financial players or - as described in the EESC opinion [14] – generate a self-fulfilling prophecy. On this point, there is an overlap between this proposal and the amendments to the CRA regulation, proposed on the same day. This twin-track approach is logically consistent. Amongst financial market players, for whom these (external) ratings are intended, use of the automatic approach is to be prevented or in any case limited; in measures for regulating rating agencies, steps should be taken to ensure they are as transparent as necessary and provide the required information to market participants.

3.5 The fact that UCITS and AIF bear some responsibility of their own for preventing the development of a herd mentality and chain reactions should not be overlooked. Insofar as their risk management systems permit that kind of effect, they are part of the problem. The EESC strongly supports the Commission in its assessment of this. For that reason, what matters too in the implementation of this proposal, is above all that the delegated acts also put the legislators' intentions into practice appropriately. Moreover, any financial regulation is only as good as its ultimate implementation in practice in the course of supervisory activities.

4. **Specific comments**

4.1 There is no doubt that routine, automatic and unchecked acceptance of external ratings does or can lead to parallel selling-off of equivalent securities and can thus trigger upsets on the market which jeopardise financial stability. This is also the conclusion reached in the Commission's comprehensive consultation [15], the non-legislative resolution of the European Parliament of 8 June 2011 [16] and the principles of the Financial Stability Board, FSB) [17].

4.2 A series of measures is necessary to put a stop to this automatic approach. First of all, steps have to be taken to ensure that all possibilities are being used and further developed so that different creditworthiness standards are also employed as an alternative to ratings from the big agencies. At the same time the existing supervisory rules have to be checked, which - based on laws or administrative rules - generate an automatic link between an external rating and an assessment, as is the case with credit institutions and insurance companies. Moreover, the same measures should put a stop to the automatic responses in financial players' risk management systems. In general, it is necessary to ensure that no provisions requiring these automatic responses remain in EU or national law. It should also be ensured that private-law contracts which provide for automatic responses of this kind are deemed invalid. Furthermore, financial players require adequate information to facilitate their own assessments.

4.3 The proposal contains, as a general guideline, the necessary clarification for shaping UCITS' and AIF's risk management systems. This approach is essentially the right one. It will in any case only become a reality once the corresponding delegated acts are put in place, which means that the main task of preventing misdirection caused by the automatic acceptance of external ratings still has to be carried out.

[10] See footnote 2.
[11] See footnote 2, point 1.2.
[12] COM (2011)747 final – 2011/0361 (COD).
[13] See footnote 2.
[14] See footnote 2, point 1.7.
[15] See footnote 6.
[16] *Resolution of the European Parliament of 8 June 2011 on credit rating agencies: future perspectives* (2010/2302 (INI)).
[17] See footnote 6.

4.4 In practice, a full withdrawal from the use of external ratings will not be feasible. Nowadays, the requisite resources for replacing external ratings, as well as the necessary expertise and experience, are only available to a limited extent. Small financial institutions in particular do not always have the means needed to expand or build up their own analysis departments. In addition to the possibility of carrying out more risk assessments internally and the concomitant independence from external rating agencies, the Committee once again calls for SMEs to have the possibility to farm out such risk analysis. By facilitating access to external information, expertise can certainly be built up on specialist markets by means of cooperation and greater cost efficiency generated. This would put small and medium-sized enterprises in particular in a position to achieve greater independence from credit rating agencies. Measures going in this direction are to be welcomed. The Committee is convinced, however, that the actual decision on the creditworthiness of an investment must always be taken by the company; i.e. it must not be outsourced.

4.5 The EESC understands that implementing this proposal may well raise the cost, sometimes significantly, of regulating this domain by expanding risk management systems, such as through the expansion and development of internal arrangements. In view of the threat that the whole of society might suffer damage, there is in any case no alternative.

Brussels, 23 May 2012.

The President
of the European Economic and Social Committee
Staffan NILSSON