

Communication from the Commission on Credit Rating Agencies

(2006/C 59/02)

(Text with EEA relevance)

1. INTRODUCTION

Credit rating agencies play a vital role in global securities and banking markets. It is essential, therefore, that they consistently provide ratings which are independent, objective and of the highest possible quality.

The Commission made a commitment to analyse the issue of credit rating agencies at the Oviedo Informal ECOFIN Council (April 2002), in the aftermath of the Enron scandal. The European Parliament then adopted (February 2004) a Resolution on credit rating agencies ⁽¹⁾, following an own initiative report from its Committee on Economic and Monetary Affairs ⁽²⁾, calling on the Commission to produce an assessment of the need (if any) for legislative intervention in this field. In March 2004, following the Parmalat scandal, the Commission identified, in cooperation with the European Parliament and the Member States, the main regulatory issues of concern with regard to credit rating agencies. In July 2004, the Commission asked the Committee of European Securities Regulators ('CESR') to provide the Commission with technical analysis and advice to assess the need for introducing European legislation or other solutions. CESR provided its advice to the Commission in March 2005 ⁽³⁾. Meanwhile, a number of key EU legislative measures with major implications for credit rating agencies have been adopted as part of the Commission's Financial Services Action Plan (FSAP). Moreover, the International Organisation of Securities Commissions ('IOSCO') published in December 2004 its Code of Conduct Fundamentals for credit rating agencies ('IOSCO Code') ⁽⁴⁾.

The purpose of this Communication is to report back to the Council and European Parliament on the Commission's regulatory approach towards credit rating agencies, bearing in mind these latest developments. In developing this approach, the Commission has been guided by the advice provided by CESR. It has also sought to adhere to the principles of 'Better Regulation' to which the Commission has committed itself as part of the drive to boost growth and employment in the Union and

which form a crucial part of its approach to financial services policy set out in its recent White Paper ⁽⁵⁾.

2. CREDIT RATING AGENCIES

2.1 Functioning of credit rating agencies

Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument. In other words, they assess the likelihood that an issuer will default either on its financial obligations generally (issuer rating) or on a particular debt or fixed income security (instrument rating).

These opinions — or ratings — are based on information relating to revenue stream and balance sheet (with particular focus on the debt) of the rated entity. Past financial performance is also considered. They only give an indication as to the situation at a given time and must therefore be periodically confirmed or revised to take account of recent economic or other developments. The credit ratings effectively categorise issuers into corresponding grades, depending on whether they are considered as more or less default-prone. Credit rating agencies employ comprehensive creditworthiness scales, with the critical border line running between the so-called investment grade (low-risk) and speculative grade (high-risk), reflecting the risks related to the security (i.e. the likelihood of default).

Ratings are usually requested — and paid for — by the issuers themselves. In these cases, they are based on both publicly available data and information which is not accessible to the public but which is voluntarily disclosed by the rated entity (e.g. by means of interviews with senior financial officials of the rated entity). However, credit rating agencies sometimes issue unsolicited ratings (i.e. ratings which have not been requested by an issuer). These are usually prepared without access to non-public information.

Although the provision of ratings is obviously their core activity, many credit rating agencies make use of their expertise in risk assessment to provide other financial services (e.g. investment advice) to issuers (either directly or through related entities).

⁽¹⁾ European Parliament resolution on Role and methods of rating agencies (2003/2081(INI)), available at: [http://www.europarl.eu.int/registre/seance_pleniere/textes_adoptes/definitif/2004/0210/0080/P5_TA\(2004\)0080_EN.pdf](http://www.europarl.eu.int/registre/seance_pleniere/textes_adoptes/definitif/2004/0210/0080/P5_TA(2004)0080_EN.pdf).

⁽²⁾ Report of the Committee on Economic and Monetary Affairs (A5-0040/2004); rapporteur Giorgos Katiforis.

⁽³⁾ CESR's technical advice to the European Commission on possible measures concerning credit rating agencies, CESR/05/139b, March 2005, available at: <http://www.cesr-eu.org>.

⁽⁴⁾ Code of Conduct Fundamentals for Credit Rating Agencies, The Technical Committee of the International Organization of Securities Commissions, December 2004, see Annex on IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

⁽⁵⁾ White Paper on Financial Services Policy (2005-2010), COM(2005) 629 final.

2.2 Impact on the financial markets

Credit ratings carry considerable weight in financial markets. There are two basic reasons for this. First, although they are based on complex assessments they can be easily and instantly assimilated by investors regardless of their expertise and profile. Secondly, credit rating agencies enjoy a good reputation and are seen by market participants to be providing unbiased data analysis.

The importance of credit rating agencies in recent years can be observed in both business practice and regulatory requirements. On the one hand, the commercial success of most debt instrument issues largely depends on the rating granted. A rating has become a pre-requisite for seeking external financing in the securities markets (especially when issuers do not have an established presence on the debt markets). The credit rating of an issuer determines the interest rates that they will have to offer in order to obtain external financing. Moreover, credit ratings are increasingly used in contractual provisions regarding the termination of credit availability, acceleration of debt repayment or modification of other crediting conditions.

On the other hand, several jurisdictions now insist that certain types of investment products can only be sold if the issuer can demonstrate a certain grade of creditworthiness reflected in a rating issued by a recognised credit rating agency. Credit rating agencies are also increasingly involved in the assessment of the risks associated with assets held by financial institutions which are subject to capital adequacy requirements.

The role which credit rating agencies play in the markets is generally very positive for both investors and issuers. They provide investors with information which helps them to assess the risks related to a security. And they help to lower the costs of raising capital for issuers (or at least for those issuers who receive a favourable rating).

2.3 Issues of concern

The Resolution of the European Parliament does not call into question the positive role that credit rating agencies can and generally do play. However, it identifies a number of issues of concern which require serious attention in order to ensure that all credit rating agencies exercise their functions responsibly at all times⁽⁶⁾.

Concern centres on the quality of credit ratings provided by credit rating agencies. Credit rating agencies must base their ratings on a diligent analysis of the available information and control continuously the integrity of their information sources. This means that credit ratings must be regularly updated, if

necessary. Credit rating agencies must also be more open about the way in which their ratings are arrived at. In addition, it is important that credit rating agencies are independent and entirely objective in their approach. The position of credit rating agencies must not be compromised by the relationships which they have with issuers. There are also concerns relating to the access which credit rating agencies have to inside information of issuers. It is important that credit rating agencies are prevented from using this information for other activities. Finally, the European Parliament expressed concern about the degree of concentration in the ratings industry and its possible anti-competitive effects.

3. RELEVANT REGULATION

The issues relating to credit rating agencies are serious and must be tackled. Both the new EU-level legislative framework and the IOSCO Code seek to do this. The EU legislation applies only to credit rating agencies operating in the EU. The Code, on the other hand, is expected to be applied by credit rating agencies in all jurisdictions where they operate. In terms of content, the Code complements the EU legislation. While the Directives are legally binding, the Code works on a 'comply or explain' basis — i.e. credit rating agencies are expected to incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct. Where they choose not to do this, they must explain how their Code nevertheless gives effect to the provisions of the IOSCO Code.

3.1 EU legislation

The aim of the FSAP was to create open, integrated and efficient financial markets in the EU — where competitive forces maximise investors' returns — but where investors are not subject to excessive risk. It therefore sought to minimise the regulatory burden on firms while at the same time maintaining an effective level of regulatory control and a high level of investor protection.

There are three FSAP Directives which are relevant to credit rating agencies. The most important is the **Market Abuse Directive** ('MAD') which — together with its implementing Regulation and Directives⁽⁷⁾ — tackles the issue of insider dealing and market manipulation (market abuse) in order to ensure the integrity of Community financial markets and to enhance investor confidence in those markets. Insider dealing and market manipulation prevent full market transparency, which is important for trading for all economic actors in integrated financial markets. In the field of conflicts of interest, fair presentation of investment recommendations and the access

⁽⁷⁾ Directive 2003/6/EC of 28/01/03 (OJ 2003 L 96/16); Commission Directive 2003/124/EC of 22/12/03 (OJ 2003 L 339/70); Commission Directive 2003/125/EC of 22/12/03 (OJ 2003 L 339/73); Commission Directive 2004/72/EC of 29/04/04 (OJ 2003 L 162/70) and Commission Regulation (EC) No 2273/2003 of 22/12/03 (OJ 2003 L 336/33).

⁽⁶⁾ See footnote 1.

to inside information, the provisions of the Market Abuse Directives constitute a comprehensive legal framework for credit rating agencies while, at the same time, acknowledging their specific role and the differences between credit ratings and investment recommendations.

In order to prevent insider dealing and market manipulation, the Directive 2003/125/EC addresses the fair presentation of investment recommendations and the disclosure of conflicts of interest. For the purposes of the said Directive, credit ratings do not constitute a recommendation but they are regarded as opinions on the creditworthiness of a particular issuer or financial instrument. Nevertheless, it is stipulated that credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented. Moreover, it is stated that a credit rating agency discloses any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate⁽⁸⁾. Additionally, it follows from the Directive 2003/6/EC that, in case a credit rating agency knew, or ought to have known, that the credit rating was false or misleading, the prohibition to disseminate false or misleading information, constituting market manipulation, may apply to credit ratings⁽⁹⁾. Considering these provisions, it is clear that credit rating agencies need to implement internal procedures and policies to ensure objective, independent and accurate credit ratings which will benefit investor confidence. It is of major importance for the Commission that credit rating agencies will effectively enforce their procedures to ensure high quality of credit ratings.

With respect to the legal treatment of credit rating agencies' access to inside information, the Directive 2003/6/EC prohibits any person possessing inside information from using that information by acquiring or disposing of financial instruments to which that information relates. Inside information is defined as information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments and which, if it were made public, would be likely to have a significant effect on the price of those financial instruments or on the price of related derivative financial instruments⁽¹⁰⁾. As a rule, an issuer must disclose inside information as soon as possible. Consequently, there will be few circumstances in which an issuer can legitimately be in possession of inside information that has not already been disclosed to the market. If an issuer decides to allow a credit rating agency access to inside information, the credit rating agency would owe a duty of confidentiality as required by Article 6(3) of Directive 2003/6/EC.

⁽⁸⁾ See Article 1(8) and recital 10 of Directive 2003/125/EC.

⁽⁹⁾ Article 1(2) under c stipulates that 'market manipulation shall mean: dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person knew, or ought to have known, that the information was false or misleading.(...)'

⁽¹⁰⁾ Article 1(1) and 2(1) of Directive 2003/6/EC.

As a result, a credit rating agency or an employee who has access to inside information of any sort is prohibited from any trading using inside information. Moreover, it is not allowed to disclose this inside information to anyone else except in the normal course of employment, profession or duties. In this respect, Article 6(3), third subparagraph of Directive 2003/6/EC states that issuers, or persons acting on their behalf or for their account, draw up list of persons working for them who have access to inside information. This provision allows Member States to require credit rating agencies to draw up lists of insiders. These lists must regularly be updated and transmitted to the competent authority whenever the latter requests it.

In addition to having access to inside information of the issuer, it is possible that a credit rating itself constitutes inside information, in particular when the credit rating agency has access to non-public information of the issuer. This implies that using the unpublished rating for trading or disclosing this information to anyone else, except in the normal course of employment, profession or duties, is prohibited. However, a credit rating agency communicating an imminent rating publication to the issuer on a confidential basis for the purpose of checking the accuracy of the information it is based on would be allowed.

The Commission believes that the provisions of the Market Abuse Directives provide a comprehensive set of rules for the activities of credit rating agencies in the area of market abuse concerns. The specific role of credit rating agencies in the financial markets requires diligent application of these provisions. Consequently, the Commission will monitor actively the implementation and enforcement of these provisions in the Market Abuse Directives in relation to credit rating agencies.

The second item of EU legislation which is relevant to credit rating agencies is the **Capital Requirements Directive** ('CRD') which introduces a new capital requirements framework for banks and investment firms⁽¹¹⁾. The CRD is based on the new international capital requirements framework agreed by the Basel Committee on Banking Supervision ('Basel II') in 2004.

The CRD provides for the use of external credit assessments in the determination of risk weights (and consequential capital requirements) applied to a bank or investment firm's exposures. Only the use of assessments provided by recognised External Credit Assessment Institutions ('ECAIs'), mainly credit rating agencies, will be acceptable to the competent authorities. A recognition mechanism is also outlined in the Directive.

⁽¹¹⁾ Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions.

The CRD sets out a number of requirements which ECAIs should meet before the competent authority grant them recognition. For example, their ratings must be objectively and independently assigned and reviewed on an ongoing basis. In addition, their rating procedures should be sufficiently transparent. In addition, the competent authorities should assess whether individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments and accessible at equivalent terms to all interested parties.

Building on the CRD, the Committee of European Banking Supervisors ('CEBS') is working to promote convergence of the recognition processes of ECAIs across the EU by defining a common understanding on the criteria necessary to implement the recognition requirements laid down in the CRD ⁽¹²⁾.

Clearly, the CRD does not constitute a form of regulation of credit rating agencies on how to do business but focuses predominantly on the weighting of capital requirements. Consequently, the recognition process of ECAIs does not address the broader conduct of business issues concerning credit rating agencies in general. Moreover, credit rating agencies may choose not to become ECAIs under the CRD and therefore the CRD may not cover the entire population of credit rating agencies. However, the objectives and effects of the ECAI recognition system cannot be seen separately from the aims of other legislation and supervisory standards applicable to credit rating agencies since the CRD affirms the meaningful function of credit rating agencies. To this end, the Commission will closely monitor developments with regard to the recognition of ECAIs and assess whether credit rating agencies perform their important role adequately under the CRD. Hence, competent authorities should ensure that the effects of recognition are shared with all stakeholders in order to assess whether the ECAI recognition criteria could be used in the future for conduct of business regulation of credit rating agencies, if this appears to be necessary.

The final piece of relevant legislation is the **Markets in Financial Instruments Directive** ('MiFID') ⁽¹³⁾. MiFID and its future implementing measures are not applicable to the rating process of credit rating agencies in the case where the rating process itself does not involve the firm undertaking investment services and activities as defined in the MiFID. In other words, the issuing of a credit rating will normally not result in the credit rating agency also providing 'investment advice' within the meaning of Annex I to the MiFID. But credit rating agencies should be aware of the precise limits of this activity in order to continue to operate outside MiFID regulation. However, credit rating agencies that also provide investment services and activities on a professional basis may require authorisation. In such

cases, the MiFID provisions regarding conduct of business and organisational requirements will apply to the firm and its undertaking of investment services and activities. Where, for example, a credit rating agency provides investment services (such as investment advice) to clients that fall under the MiFID, the provisions on conflicts of interest will apply to protect the interest of those who receive these services. The provisions on conflicts of interest may require an appropriate degree of separation of investment services from the credit rating process so that ancillary services may not interfere with the quality and objectivity of credit ratings ⁽¹⁴⁾.

This comprehensive legal framework is now being put in place by the Member States. All Directives must be correctly implemented. Consequently, the transposition of the Directives is actively monitored by the Commission. It may initiate infringement procedures on the grounds of incorrect or non-transposition of the Directives, where necessary.

Another area of Community law which is potentially important for credit rating agencies is **competition law**. The Commission does not share the European Parliament's concerns about the degree of concentration in the ratings industry. There is no indication of any anti-competitive practices in this industry but any evidence to the contrary will be examined thoroughly. The Commission does not therefore see the need for action in this area at the moment. Moreover, one could conceive that in this particular industry, excessive market fragmentation could have adverse consequences (i.e. credit rating agencies may face undue pressure to issue favourable ratings in order to attract clients).

3.2 The IOSCO Code

In September 2003, IOSCO published its Principles Regarding the Activities of Credit Rating Agencies ('IOSCO Principles') ⁽¹⁵⁾, setting high-level objectives for credit rating agencies, securities regulators, issuers and other market participants to improve investor protection and market fairness, efficiency and transparency and to reduce systemic risk. In response to comments on these principles, IOSCO developed the IOSCO Code of Conduct Fundamentals for credit rating agencies (see Annex).

Reflecting the global nature of the market for credit rating agencies, the IOSCO Code is meant to be applied by rating agencies of all sizes and business models and in every jurisdiction. The Commission notes that the IOSCO Code has not been implemented into the national law of Member States. However, credit rating agencies are expected to give full effect to the provisions of the IOSCO Code — as long as these provisions are consistent with the EU Directives. This requires that credit

⁽¹²⁾ CEBS Consultation paper on the recognition of External Credit Assessment Institutions, 29 June 2005, available at <http://www.cebs.org/pdfs/CP07.pdf>

⁽¹³⁾ Directive 2004/39/EC of 21/04/04 (OJ 2004 L 145/1).

⁽¹⁴⁾ See Articles 13(3), 13(10) and 18 of the MiFID.

⁽¹⁵⁾ IOSCO's Principles Regarding the Activities of Credit Rating Agencies, available at www.iosco.org/IOSCOPD151.

rating agencies incorporate the IOSCO Standards in their procedures. Recent market developments show that several credit rating agencies have set up their own Codes of Conduct along the lines of the IOSCO Code which proves that the latter provides a useful set of standards for self-regulation of the credit rating industry.

It is very important that credit rating agencies not only incorporate the IOSCO Code in their own Code of Conduct but fully comply with the IOSCO Code by enforcing their Code of Conduct in daily practice. Credit rating agencies need to inform regularly in the coming years all stakeholders about their compliance with their Codes of Conduct. To this end, the Commission recommends to analyse the effects of the IOSCO Code on a regular basis.

4. CONCLUSION

Following the request by the European Parliament, the Commission has considered very carefully whether or not fresh legislative proposals are required to regulate the activities of credit rating agencies.

Its conclusion is that at present no new legislative initiatives are needed. One of the central principles of 'Better Regulation' is that legislative solutions should be applied only where they are strictly necessary for the achievement of public policy objectives. The Commission believes that the case for new legislation in this area remains unproven.

There are already three new financial services Directives which cover credit rating agencies. The Commission is confident that these Directives — when combined with self regulation by the credit rating agencies themselves on the basis of the newly adopted IOSCO Code — will provide an answer to all the major issues of concern raised by the European Parliament.

In its advice to the Commission, CESR also indicated that the right balance between legislation and self-regulation had been struck and that no further regulatory initiatives were needed for the time being.

However, the Commission is continuing to monitor developments in this area very carefully. It is clear that the new arrangements will only produce the desired results if credit rating agencies take the task of regulating themselves sufficiently seriously. They must be scrupulous in implementing the provisions of the IOSCO Code. And they must be open and transparent about the way in which they are doing it.

It is encouraging that many credit rating agencies have established their own Codes of Conduct based on the IOSCO Code. But establishing these Codes in itself is not enough; they must also be implemented in practice on a day to day basis. The Commission intends to ask CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis. It will also consider how best to gauge the opinions of market participants, especially those purchasing complex financial instruments. This might include the setting up of an informal expert group. The ratings industry should be aware that the Commission may have to take legislative action if it becomes clear that compliance with EU rules or the Code is unsatisfactory and damaging EU capital markets.

The Commission will also consider introducing legislative proposals if new circumstances arise — including serious problems of market failure.

Finally, the Commission intends to monitor the global development of the rating business. If there are significant changes in the way credit rating agencies are regulated in other parts of the world, it may be necessary for the Commission to re-evaluate its approach.