Opinion of the European Economic and Social Committee 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(2011) 747 final — 2011/0361 (COD)

(2012/C 181/13)

Rapporteur: **Mr PÁLENÍK**

On 13 December 2011 and 30 November 2011, respectively, the Council and the European Parliament decided to consult the European Economic and Social Committee, under Articles 114 and 304 of the Treaty on the Functioning of the European Union, 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(2011) 747 final — 2011/0361 (COD).

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 7 March 2012.

At its 479th plenary session, held on 28 and 29 March 2012 (meeting of 29 March 2012), the European Economic and Social Committee adopted the following opinion by 118 votes to 32 with 15 abstentions.

1. Conclusions and Recommendations

1.1 This opinion has been drafted in connection with the adoption of the Commission proposal aimed at eradicating major shortcomings in transparency, independence, conflict of interest, and the quality of procedures used in making ratings and ratings procedures. The EESC welcomes the fact that the proposed regulation seeks to eliminate these problems, but thinks that the Commission's reaction to the situation that has arisen is tardy and does not go far enough.

1.2 Credit rating agencies play an important role in the global financial markets because many market participants use their ratings. They thus have a substantial influence on the making of informed investment and financial decisions. For this reason, it is essential that credit rating be carried out in accordance with the principles of integrity, transparency, responsibility and good governance, to which the current regulation on credit rating agencies already makes a significant contribution.

1.3 In the view of the EESC, markets are not themselves capable of self-regulation, so it is essential to introduce the most stringent rules possible, matched by commensurate implementation and scrutiny. However, the proposal gives no clear indication of how regulation is to be implemented. In addition, the EESC very much doubts that the hoped-for results can be achieved simply by tightening up the rules, which would serve rather to reduce the responsibility of the various monitoring bodies even further. These bodies should, on the contrary, be more involved in evaluating the ratings issued by agencies.

1.4 The EESC takes the view that the European dimension as set out in the proposed regulation needs to be buttressed as far as possible by negotiations at G20 level with a view to these countries implementing similar rules to ensure consistency worldwide.

1.5 To secure a broader range of credit ratings, the proposal establishes a mandatory rotation of the agencies providing them. However, the EESC questions whether bringing in this rule will indeed produce the desired outcome.

1.6 In the Committee's view, one of the fundamental problems is the credibility of the ratings provided by the agencies, most of which are based in the USA and are exposed to multiple conflicts of interest. This is why the EESC calls on the Commission to set up an independent European rating agency which can rate sovereign debt with a view to the common interest. Rating agencies have a history of failing to foresee developments and this, too, has dented their credibility. Despite clear signs from the market and from economic trends, they lacked the ability or the will to indentify investments risks in time and failed, in many instances, in performing their essential function.

1.7 Precisely because they are unable to forecast future developments properly and, above all, because there is something of the self-fulfilling prophecy about credit ratings, the inadequate transparency of the methods agencies use in making their ratings has to be examined more closely.

1.8 The EESC has grave doubts about the independence of the ratings delivered, especially because of the 'issuer pays' mechanism. Indeed, it is convinced of their partial lack of independence. Clearly, the issuer has every interest in securing the highest possible rating and this raises doubts about the independence of the rating given, which often covers up an act of speculation in reaction to an announcement effect.

1.9 It is absolutely vital that all the points addressed in the proposal are actually taken up and acted upon. It must be ensured that they really are respected at both EU level and nationally. In the Committee's view, ESMA will have to be given the necessary means to ensure such compliance.

1.10 In this context, the EESC welcomes the changes to rating agencies' civil liability and urges the Commission to improve actual protection of consumers of financial products, setting up effective avenues of redress that enable them to exercise their rights and obtain compensation, without prejudice to any penalties imposed on the agency by the supervisory body.

1.11 Conflict of interest remains a fundamental problem and the proposal contains a number of measures to address it. However, the EESC stresses once again that these are not enough to secure the intended goal. The reason for this is the 'issuer pays' model, especially when it comes to issuing requested ratings and country ratings. Negative sovereign debt ratings and outlooks benefit buyers of the bonds issued, in the form of higher interest rates and risk premiums. In some cases, those buyers may be the same entities as the issuers that pay credit rating agencies for rating their financial instruments, which could create possible conflicts of interest.

1.12 The EESC welcomes not just the endeavour to put paid to a number of problems (transparency, conflict of interest, independence and competition) and tighten up scrutiny of how ratings agencies (key players in financial markets) operate, but also the fact that the 2011 regulation also takes on some other important issues, especially the creation of a European framework for monitoring rating agencies [1].

1.13 The EESC considers, however, that credit rating agencies are a political rather than simply a legal issue. Consequently, the best way to protect sovereign debt from the – often pernicious – effects of agency ratings is not only to have better and limited rules, but also:

- to prohibit them from issuing sovereign debt ratings;
- to broaden the remit of the ECB to match that of all other central banks in the world and so remove its current handicap;
- to improve the current management of euro area sovereign debt (see opinion ECO/307- CESE 474/2012).

2. Rationale

2.1 The current, deepening credit crisis is linked to the earlier banking crisis, which was caused by serious failures in the regulation and supervision of financial institutions and to which the European Community reacted swiftly and appropriately by adopting Regulation (EC) No 1060/2009. This new crisis highlights the need for further improvements in the effectiveness of a number of activities in the field of regulation and supervision of financial institutions. Regulation (EC) No 1060/2009 on credit rating agencies lays down strict rules of conduct for these agencies, with the primary goal of mitigating possible conflicts of interest and ensuring the high quality and transparency of ratings and rating processes.

2.2 It must not be forgotten that credit rating agencies are incapable of predicting real future developments, which means they have a downright harmful impact on countries' economies. The catalogue of dubious agencies is long, so here are just a few:

- In 1975 the city of New York received a very favourable rating on the eve of announcing bankruptcy (cessation of payments);
- A little later, Standard and Poor's assured investors that the economy of Orange County (California) was healthy and well managed, despite the fact that USD 2 billion had gone up in smoke thanks to speculation in derivatives. The agency subsequently had to face a number of lawsuits [2];
- There were similar cases involving the Long Term Capital Management hedge fund, the Bank of Credit and Commerce International (BCCI), the collapse of US savings banks and the fraudulent collapses of Enron, Worldcom, Tyco etc. and Lehman Brothers [3];
- Before the financial crisis, agencies were giving even the most suspect (subprime) mortgage derivatives a rating of AAA, which convinced investors – including pensions funds – to buy them in bulk [4];
- Before the financial crisis erupted in 2008, rating agencies unanimously awarded the best rating to banks and funds that owned the most worthless – speculator conceived – securities, as in the case of the US insurance company AIG [5];
- In December 2009, for example, Standard and Poor's gave Greek debt a rating of A- – the same as Estonia, which was preparing to enter the euro area at the time [6].

[1] EESC opinion on Credit Rating Agencies, OJ C 54, 19.2.2011 p. 37.

[2] Ibrahim Warde, 'Ces puissantes officines qui notent les Etats', Le Monde diplomatique, February 1997.

[3] Marc Roche, 'Le capitalisme hors la loi', Éditions Albin Michel 2011, p. 70.

[4] Joseph E. Stiglitz, 'Le triomphe de la cupidité', Les lines qui libèrent 2010, p. 166.

[5] Hervé Kempf, 'L'oligarchie ça suffit, vive la démocratie', Éditions du Seuil, Paris 2011, p. 72.

[6] Idem.

2.3 Now, when the whole of Europe is languishing in a debt crisis and some countries are teetering on the edge of bankruptcy, it will be extremely important for the Commission to do everything in its power to nurture the resurgence of the economy. The present proposal is an instrument well suited to stiffening this endeavour, but it needs to be more ambitious.

2.4 It is wanting in its approach to sovereign debt ratings – not to mention that the point of these ratings is itself questionable, since countries with the same rating still end up paying different interest rates. Also stemming from this is the question – still up in the air – of the political value of these agency ratings.

2.5 In its consultation paper [7], which was the outcome of a public consultation exercise during the course of 2010, the European Commission set out options for resolving problems related to excessive reliance on ratings by market participants and drew attention to the need to introduce independent assessment of credit risks by investment firms, support for greater competition in the credit rating market, the introduction of civil liability for credit rating agencies and the options for resolving the potential conflicts of interest resulting from use of the 'issuer pays' model.

2.6 A number of respondents to the public consultation organised by the European Commission between 5 November 2010 and 7 January 2011 expressed concern over excessive or even mechanical reliance on credit ratings and also supported a gradual reduction of references to credit ratings in legislation. At the same time, they highlighted the fact that finding suitable instruments with which to replace them would be an important part of the search for an appropriate solution.

2.7 The European Parliament, which issued a non-legislative resolution on credit rating agencies on 8 June 2011, also endorsed the need to improve the regulatory framework for credit rating agencies and to adopt suitable measures to reduce excessive reliance on credit ratings [8].

2.8 The European Council of 23 October 2011 [9] concluded that strengthening financial regulation remained a key priority for the EU and welcomed the fact that much had been achieved since 2008 with the reform of the regulatory and supervisory framework, but called for efforts to be maintained to identify and address the weaknesses of the financial system to prevent future crises.

2.9 At the international level, the Financial Stability Board (FSB) issued in October 2010 principles to reduce authorities' and financial institutions' reliance on CRA ratings [10]. Endorsed by the G20 Seoul Summit in November 2010, these principles call for removing or replacing references to such ratings in legislation where suitable alternative standards of creditworthiness are available and for requiring investors to make their own assessments of creditworthiness.

2.10 For these reasons, Regulation (EC) No 1060/2009 on credit rating agencies needed to be amended, particularly in order to reduce the potential risks associated with excessive reliance by market participants on credit ratings, the high degree of concentration on the credit rating market, the establishment of civil liability of rating agencies vis-à-vis investors, conflicts of interests relating to the 'issuer pays' model and the shareholder structure of credit rating agencies.

3. Gist of the amendments to Regulation (EC) No 1060/2009

3.1 *Extension of the scope of application of the regulation to cover rating outlooks*

3.1.1 The Commission proposal extends the scope of the rules on credit ratings to cover, where appropriate, 'rating outlooks'. The importance of rating outlooks for investors and issuers, and their impact on the market, is comparable to the importance and effects of credit ratings and credit rating agencies are therefore required, in particular, to disclose the time horizon within which a change of credit rating is expected.

3.2 *Amendments in relation to the use of credit ratings*

3.2.1 The proposal for a regulation on credit rating agencies also adds a provision obliging certain financial institutions to carry out their own credit risk assessment, with the aim of reducing excessive or even mechanical reliance solely on external credit ratings for assessing the creditworthiness of assets.

3.3 *Amendments in relation to the independence of credit rating agencies*

3.3.1 The independence of credit rating agencies under the current 'issuer pays' model needs to be strengthened in such a way as to increase the level of credibility of credit ratings.

3.3.2 One respect in which independence is strengthened, by eliminating conflicts of interest, is the rule that any shareholder or member of a credit rating agency who holds a participation of at least 5 % in that agency may not hold a participation of 5 % or more in any other credit rating agency, unless the agencies concerned are members of the same group.

3.3.3 A rotation rule is introduced for credit rating agencies engaged by the issuer to rate either the issuer itself or its debt instruments. The outgoing credit rating agency is also required to hand over all documents containing relevant information to the incoming rating agency.

[7] http://ec.europa.eu/internal_market/securities/docs/agencies/summary-responses-cra-consultation-20110704_en.pdf.
[8] http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=en&procnum=INI/2010/2302.
[9] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125496.pdf.
[10] http://www.financialstabilityboard.org/publications/r_101027.pdf.

3.3.4 At the same time, the rule on internal rotation of staff is adjusted in order to prevent analysts from moving to another credit rating agency with a client file.

3.3.5 A credit rating agency should not issue credit ratings where there are conflicts of interest created by the involvement of individuals who hold more than 10 % of the capital or voting rights in the agency or who hold another important position.

3.3.6 Individuals holding more than 5 % of the capital or voting rights in the credit rating agency and individuals who hold other important positions should not be allowed to provide consultancy or advisory services to the rated entity.

3.4 *Amendments in relation to the disclosure of information on methodologies of credit rating agencies, credit ratings and rating outlooks*

3.4.1 Procedures are proposed for the preparation of new rating methodologies or the modification of existing ones, and consultation of stakeholders must also be integrated into that process. As the competent authority, ESMA will assess the compliance of proposed new methodologies with existing requirements, and the use of those methodologies will only be allowed once they have been approved by ESMA.

3.4.2 If errors are found in the methodologies, the credit rating agencies should have an obligation to remove the errors and to inform ESMA, the rated entities and the public generally of those errors.

3.4.3 The issuer will have to be informed of the main reasons for the assessment at least one full working day before publication of a rating or rating outlook, to give it an opportunity to detect possible errors in the rating assessment.

3.4.4 Credit rating agencies should disclose information about all entities or debt instruments submitted to them for their initial review or for preliminary rating.

3.5 *Amendments in relation to sovereign ratings*

3.5.1 In an effort to improve the quality of sovereign credit ratings, the rules relating to those ratings will be strengthened and their frequency of assessment will be increased to at least once every six months.

3.5.2 In order to increase transparency and raise the level of understanding among users, credit rating agencies should be obliged to publish a full research report when issuing and amending sovereign ratings.

3.5.3 Credit rating agencies will also provide disaggregated data on their turnover, including data on the fees generated per different asset classes. This information should allow an assessment to be made of the extent to which credit rating agencies use their resources to issue sovereign ratings.

3.6 *Amendments in relation to the comparability of credit ratings and fees for credit ratings*

3.6.1 All credit rating agencies will be obliged to communicate their ratings to ESMA, which will publish the available ratings for debt instruments in the form of a European Rating Index (EURIX).

3.6.2 ESMA will be able to develop draft technical standards for the Commission on a harmonised rating scale. All ratings will follow the same scale standards, ensuring easier comparability of ratings.

3.6.3 Fees for the provision of rating assessments should be non-discriminatory and unconditional, that is to say taking account of actual costs and transparent pricing, and should not depend on the result of the assessment. Credit rating agencies should provide an annual list of fees charged to clients for individual services.

3.6.4 ESMA should also carry out monitoring activities regarding market concentration, the risks arising from concentration and the impact on the overall stability of the financial sector.

3.7 *Amendments in relation to the civil liability of credit rating agencies vis-à-vis investors*

3.7.1 In the new provisions, the Commission proposes to make it possible to bring a claim for damages caused by breach, intentionally or with gross negligence, of the obligations arising from the regulation on credit rating agencies, where that breach has affected a credit rating on which the investor has relied.

3.8 *Other amendments*

3.8.1 On certain points related to credit rating agencies, the regulation is extended as appropriate to cover 'certified' rating agencies established in third countries.

4. **General comments**

4.1 The Commission proposal makes appropriate amendments to the current Regulation of the European Parliament and of the Council (EC) No 1060/2009, particularly in relation to excessive reliance by market participants on credit ratings, the high degree of concentration on the credit rating market, civil liability of credit rating agencies vis-à-vis investors, conflicts of interests with regard to the 'issuer pays' model and the shareholder structure of credit rating agencies. However, the Committee notes that the regulation lacks detail in places, and some parts are vague. It trusts that, where possible and desirable, the final version of the regulation will be more specific, clearer and less ambiguous.

4.2 The EESC is doubtful about the real trustworthiness in future of self-compiled credit assessments and consequent reliance on them. This is because, as things stand, the most trusted ratings are those established by agencies based outside the EU. If financial institutions continue to rely on their ratings, the proposed regulation is doomed to fail. At the same time, how the Commission intends to compel such assessments to be made remains a moot point.

4.3 The same is true of the proposed rotation rule: even if this rule were to give rise to a new agency to broaden the range of opinion, this new agency can itself be expected to be influenced by the views of established agencies and the anticipated diversity of opinion will thus fail to materialise.

4.4 The EESC has very serious doubts about the independence of the ratings provided, especially because of the 'issuer pays' mechanism, including in the case of country ratings, which influence the interest rates that sovereign countries pay to financial institutions and other buyers of their debt. The EESC proposes, therefore, that the Commission set about tackling the workings of the financial markets as a whole and their more stringent regulation.

4.5 The EESC supports scrutiny of how individual analysts are remunerated and the disassociation of this remuneration from the results of the rating. However, it is not clear here what tangible steps ESMA would like to take to monitor compliance with this proposal. The Committee therefore proposes that this matter be explored in greater detail.

5. **Specific comments**

5.1 The EESC reiterates the observation that compliance must be ensured with the legal framework laid down, particularly by establishing penalties for directors and managers of the European and international market supervision authorities who fail to meet their obligations, given the harm that such failure causes to banks and to the proper functioning of the financial system, as well as to the economy, businesses and individuals.

5.2 The EESC welcomes the increased effort to protect consumers of financial products by introducing civil liability of credit rating agencies, in respect of which the European Parliament and the Council have taken into account a previous EESC opinion ([11]). It believes, however, that that part should be worked out in more detail and be far clearer. It should also be clearly linked with sanctions that ESMA can impose.

5.3 The EESC has some doubt about the endeavour in the regulation to generate more competition on the credit rating market by introducing a harmonised rating scale. Nevertheless, it supports the move to the extent that it makes for better comparability of ratings.

5.4 The EESC thinks that, in attempting to improve quality, transparency, independence, plurality of views and competition in the provision of ratings, the Commission needs to set up an independent European rating agency that would issue independent sovereign debt ratings, in order to protect the common interest.

5.5 The EESC agrees with the need to restrict ownership of rating agencies to ensure they are seen to be independent, but would prefer some guarantee of their absolute independence. At the same time, it must be ensured that no investor owns – even indirectly – more than a certain percentage of the agency's capital.

5.6 The EESC fears that even providing for financial market participants to compile their own ratings and reducing reliance on external ratings will not guarantee the objectivity of decisions taken by financial market participants or a broader range of opinion. At the same time, the Committee harbours doubts about whether smaller financial institutions have the wherewithal to set up analysis units to perform these ratings.

5.7 The EESC is somewhat apprehensive regarding the application of civil law liability to rating agencies, since these agencies have on many occasions issued mistaken ratings without so far having to take responsibility – except in a very few instances – for their errors. The EESC is not convinced, therefore, that the proposed regulation will be able to change this. At the same time, the EESC thinks that it would be appropriate to strengthen civil liability, in the most coherent and effective way possible, for institutions using ratings in providing certain services, such as the liability of banks when providing investment advice.

5.8 There must be a focus, in the Committee's view, on revising the monitoring of rating agencies, which at present is not extensive enough and should be made systematic, coherent and as extensive as possible.

5.9 The EESC believes that the proposed conflict of interest rules are essential, but finds the proposal too vague on the relevant points. They need to be fleshed out in greater detail, especially when it comes to defining the obligations of the various institutions monitoring compliance.

5.10 The EESC comes to the same conclusion on the technical aspects and the way that the European Rating Index (EURIX) is actually defined, also querying here whether such an index can actually supply any additional information.

5.11 The proposal makes reference to country credit ratings, but no precise definition is given of what is meant by 'country'. This matters because the financial situation of a country is also influenced by its social and health insurance funds, which are connected, directly or indirectly, with the national budget. The public has a right to know whether coverage of their health or social needs is being jeopardised.

5.12 Country ratings must be very carefully defined, since they influence many aspects of how a country operates on the financial markets. The Commission needs to pay greater heed, therefore, to sovereign debt ratings and come up with a more detailed response.

([11]) EESC opinion on Credit Rating Agencies, OJ C 54, 19.2.2011 p. 37.

5.13 One of the prime unresolved issues remains the lack of independence of credit rating agencies, resulting in particular from the use of the 'issuer pays' model, which makes ratings appear to benefit the issuer rather than serve the needs to the investor. The EESC thinks that the introduction of a rotation rule will not be a sufficient regulatory measure to make inroads on the 'issuer pays' principle. It therefore proposes considering some other means of restricting the opportunities for issuers to choose a rating agency for their own ends.

5.14 In the EESC's view, the rotation rule as proposed does not go far enough to meet the expectations its introduction would encourage, especially regarding the creation of enough new market opportunities. For this reason, the Committee thinks that the regulation should stipulate shorter periods during which the issuer may use the services of the same rating agency or longer periods during which it may not. Another possible solution is for rating agencies to be chosen by draw. The EESC also proposes that the word 'consecutive' be removed from the phrase 'ten consecutive rated debt instruments' in the relevant articles.

Brussels, 29 March 2012.

The President
of the European Economic and Social Committee
Staffan NILSSON

APPENDIX

to the Committee opinion

The following section opinion text was rejected by the assembly in favour of an amendment, but obtained more than one-quarter of the votes.

Point 5.4

5.4 The EESC thinks that, in attempting to improve quality, transparency, independence, plurality of views and competition in the provision of ratings, the Commission needs to set up an independent European rating agency that would issue independent ratings (for which the issuer would pay), but would not issue sovereign ratings, thus sidestepping any accusation of conflict of interest.

This text of the section opinion was rejected by 78 votes against to 55 votes in favour, with 13 abstentions.