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IMPACT ASSESSMENT

Accompanying the document

Proposal for a Regulation

amending Regulation (EC) No 1060/2009 on credit rating agencies

and a

Proposal for a Directive

amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers

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1. INTRODUCTION

Regulation (EC) No 1060/2009 on credit rating agencies[1] (CRA Regulation, CRA I) entered into full application on 7 December 2010. It requires credit rating agencies (CRAs) to comply with rigorous rules of conduct in order to mitigate possible conflicts of interest, ensure high quality and sufficient transparency of ratings and the rating process. Existing CRAs had to apply for registration by 7 September 2010 and had to comply with the requirements of the Regulation by that date. Competent authorities coordinated by the European Securities and Market Authority (ESMA) [2] are currently assessing the remaining applications for registration.[3]

Furthermore, on 11 May 2011 an amendment to the CRA Regulation (CRA II)[4] was adopted, entrusting the European Securities and Markets Authority (ESMA) [5] with exclusive supervisory powers over credit rating agencies registered in the EU in order to centralise and simplify their supervision at European level. From 1 July ESMA is empowered with comprehensive investigatory powers including the possibility to demand any document or data, to summon and hear persons, to conduct on-site inspections and to impose administrative sanctions, fines and periodic penalty payments. From that date ESMA is also in charge of any new application for registration.

However, a number of issues related to credit rating activities and the use of ratings are not addressed in the existing CRA Regulation. These relate notably to the risk of over-reliance on credit ratings by financial market participants, the high degree of concentration in the rating market and, to a certain extent, remuneration models used by the credit rating agencies. Although there are a number of smaller CRAs, the rating market is dominated by three major CRAs[6] (Fitch, Moody's and Standard & Poors)[7], with a combined market share above 95 % globally.[8] Strong economies of scale in the sector as well as reputation of CRAs, which is a crucial asset, limit market entry. The specificities of certain categories of ratings, notably

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[1] Regulation of the European Parliament and of the Council on credit rating agencies of 16 September 2009, OJ L 302, 17.11.2009.

[2] The European Securities and Market Authority (ESMA) has been established by Regulation (EU) No 1095/2010 of 24 November 2010. It is an independent EU Authority that has been entrusted with the authorisation and supervision of CRAs, contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.

[3] As of 17.8.2011 eight out of 35 applicant CRAs have been registered or certified and the remaining decisions on registration are expected in September 2011 (see ESMA list of registered CRAs in Annex IV. 1.1.

[4] Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011.

[5] Regulation (EU) No 1095/2010 of the European Parliament and of the Council established the European Supervisory Authority (European Securities and Markets Authority) (ESMA), OJ L 331, 15.12.2010, page 84.

[6] A list of all registered CRAs can be found in Annex IV.

[7] Standard & Poor's and Moody's Investors Service have their head office and main management, administrative and supervisory bodies in the US. They operate in the EU through subsidiaries established in several Member States. Moody's Investor Services is owned by Moody's Corporation (listed in New York Stock Exchange - NYSE). Standard & Poor's is owned by the American publisher Mc Graw-Hill (which is a listed entity at NYSE). Fitch is dual-headquartered in New York and London and is a subsidiary of the French financial company Fimalac (listed in Euronext Paris).

[8] Finance – FAZ.NET, S & P, Moody's and Fitch: Brussels' battle against the rating oligopoly, June 2011. Available from: http://financesjournal.com/finances/moodys-fitch-brussels-battle-rating-oligopoly-5972.html.

related to sovereign debt instruments, are not sufficiently addressed either. In particular, during the recent Euro debt crisis[9], CRAs were criticised with regard to the transparency and quality of the sovereign debt ratings and the question was raised whether the EU regulatory framework for CRAs needed to be further strengthened to address this. Finally, conflicts of interest linked to the shareholder structure of CRAs and civil liability of CRAs are also not sufficiently addressed in the CRA Regulation.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Legislative process and consultation

Following the Communication of the European Commission ("Regulating Financial Services for Sustainable Growth") of 2nd of June 2010[10], in which the Commission announced the need to examine whether further regulation is needed in the area of CRAs, the European Commission conducted a public consultation from 5 November 2010 to 7 January 2011 to tackle issues not yet sufficiently addressed in the current regulatory framework.[11] The Commission received approximately 100 contributions from stakeholders which have been taken into account in the Impact Assessment. A summary of responses to the public consultation paper can be found in Annex II section 1.

On 8 June 2011 the European Parliament issued a non-legislative report on CRAs.[12] Among other proposals, the report supports measures and initiatives that would make market players (investors, banks, central banks) more engaged in risk analysis, reducing their over-reliance on ratings. In addition, the report calls for support for the creation of networks of smaller CRAs and for the establishment of a European Credit Rating Foundation and supports the establishment of a civil liability regime.

On 6 of July the Commission services held a roundtable in order to obtain further feedback from relevant stakeholders on these issues. A summary of the roundtable can be found in Annex II section 2.

2.2. Steering Group

A Steering Group for this Impact Assessment was formed by representatives of Directorate General Internal Market and Services, Directorate General Competition, Directorate General Economic and Financial Affairs, Directorate General Enterprise, Directorate General Justice, Directorate General Budget, the Legal Service and the Secretariat General and met three times, on 28 January, 4 May and 14 July 2011. The contributions of the members of the Steering Group have been taken into account in the content and shape of this impact assessment.

2.3. Impact Assessment Board

DG MARKT services met the Impact Assessment Board on 5 of October 2011. The Board analysed this Impact Assessment and delivered its opinion on 7 October 2011. During this meeting the members of the Board provided DG MARKT services with comments to improve the content of the Impact Assessment that led to some modifications of this final draft.

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9 A description and detailed analysis of the Euro debt crisis can be found in Annex VI.

10 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank. Regulating financial services for sustainable growth, COM(2010) 301 final.

11 Notably related to overreliance on external credit ratings, sovereign debt ratings, competition in the rating industry, civil liability of credit rating agencies and conflicts of interest due to the "issuer-pays" model.

12 European Parliament resolution of 8 June 2011 on credit rating agencies: future perspectives, 2010/2302(INI). Dr. Wolf Klinz was the rapporteur of this resolution.

The main comments were the following:

- Strengthen the analysis of impacts for some options and, specifically, on the proposed additional powers of the ESMA;

- Improve the analysis on implications of the limited territorial and jurisdictional applicability of EU law when evaluating the effectiveness of individual measures;

- Individual policy options should be completed by a deeper assessment of the overall impact and proportionality of the preferred package of policy options;

- Stakeholders' views should be discussed more extensively in the main text of the report.

3. POLICY CONTEXT

3.1. Role of CRAs and importance of ratings

CRAs are companies recognised in the markets as independent providers of credit opinions (ratings[13]). Their main business is to perform analyses and to issue opinions regarding the creditworthiness of companies ("corporate") and governments ("sovereign"). They also provide credit opinions on a wide range of more complex financial debt instruments, including structured finance products.

CRAs have a major impact on the financial markets, with ratings actions closely followed by investors, borrowers, issuers and governments. Investors rely on ratings as key information in determining investment decisions, depending on the degree of risk they are willing to accept. The rating given to an issuer or security will affect the cost of raising capital. Very often, a deterioration of a debtor's creditworthiness reflected in a rating change may trigger particular contractual obligations (e.g. immediate debt repayment). Finally, there are references to credit ratings in financial regulation[14], most prominently in the Capital Requirements Directive[15] (CRD), under which credit institutions are entitled to use ratings for the calculation of their capital requirements. However – and with the intention to reduce reliance on ratings - the proposal for a revised Capital Requirements Directive (CRD IV), adopted by the Commission on 20 July 2011[16], provides banks with an incentive to use internal rather than external credit ratings for the purposes of calculating regulatory capital. Also, financial institutions' internal risk management shall not rely solely or mechanically on external ratings.

Moreover, in the last few years the demand for sovereign debt ratings has increased dramatically as more and more governments and financial institutions borrow on international bond markets. Sovereign credit ratings have an important signalling effect to investors and

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13 See definition in Article 3 (1) a of the CRA Regulation

14 An overview of all references in EU financial regulation can be found in Annex 1 of the Commission consultation paper on CRAs of 5.11.2010, available from: http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf.

15 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast). OJ L 177, 30.6.2006, p. 1–200. An explanation on the Directive can be found in annex 9.1.

16 COM(2011) 453 final and COM(2011) 452 final.

rating downgrades can lead to "spillover effects"[17], with a destabilizing impact on financial markets.[18]

The euro area sovereign debt crisis has highlighted the interdependence of different financial markets and the contagion effects that rating changes may exert on the broader euro area economy. Although government officials generally cooperate with credit rating agencies and should in principle anticipate sovereign credit rating changes, many euro area Member States have recently experienced unexpected sovereign downgrades. This observation prompts issuers, investors and regulators to question the consistency, rationale and transparency of sovereign ratings, especially knowing that sovereign debt ratings have a significant impact not only on funding costs of the affected country but also on its financial sector and on the economies of other euro area Member States.[19]

3.2. Overview of the credit rating market

The credit rating market is oligopolistic and is effectively dominated by three large agencies operating globally: Standard & Poor's, Moody's Investors Service and Fitch Ratings. Moody's and Standard & Poor's have a combined market share of circa 80%, while Fitch's market share is approximately 15%.[20] In the United States, the SEC reported in 2011 that these same three firms issued 97% of outstanding ratings[21] and earned over 98% of ratings revenues. Medium and smaller credit rating agencies often cater to very specific market needs. Among them, Dominion Bond Rating Service (DBRS), Japan Credit Rating Agency, Ltd. and Rating and Investment Information, Inc. are well established regional players (in Canada/US and Japan respectively) with ambitions to develop their international market presence. Finally, there are a number of local rating agencies active in different countries, issuing rating opinions both for general purposes and for specialised uses; their impact on the global financial markets is nonetheless marginal. For more details on the CRA market structure, see Annex IV.

3.3. International-level initiatives on CRAs

Discussions on regulating CRAs have been very lively not only in Europe but also on the international scene. A full description of the various initiatives summarized in this section can be found in Annex III.

In October 2010 the Financial Stability Board (FSB) endorsed principles[22] to reduce authorities' and financial institutions' reliance on ratings. This has been approved by the

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[17] Spill-over effects are externalities of economic activity or processes affecting those who are not directly concerned. In this particular case, an externality (or transaction spill-over) is a cost, not transmitted trough prices, incurred by a party who did not agree to the action causing the cost.

[18] International Monetary Fund, World Economic and Financial Surveys Global Financial Stability Report, October 2010, page 5. Available from: http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf.

[19] The downgrades to near speculative grade ratings of some European countries have a systematic "spillover effects" across Euro zone countries. There is strong correlation between the rating-based triggers used in banking regulation, CDS contracts, and investment mandates. The main finding is that rating downgrades have statistically significant spillover effects across countries and financial markets. IMF Working Paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis, Rabah Arezki, Bertrand Candelon and Amadou N. R. Sy, 2011. Available from http://www.imf.org/external/pubs/ft/wp/2011/wp1168.pdf.

[20] See Handelsblatt of 5 July 2011, p. 6 ("Ratingagenturen- die unheimliche Macht") referring to CRA data and own research.

[21] US Securities and Exchange Commission (SEC) 2011 Annual Report on Nationally Recognised Statistical Ratings Organisations, page 7.

[22] FSB, principles for reducing reliance on CRA ratings, adopted on 27 October 2010. Available from: http://www.financialstabilityboard.org/publications/r_101027.pdf.

G20.[23] The FSB principles aim to reduce the "cliff" effects of ratings that can amplify procyclicality and cause systemic disruption. Market participants are expected to make their own credit assessments and not to rely solely or mechanistically on ratings.

The FSB has asked standard setters and regulators to consider next steps that could be taken to translate the principles into policy approaches tailored to specific financial sectors and market participants. In response to the G20 statements [24] and the FSB principles, the Basel Committee on Banking Supervision (BCBS) is currently working on specific policy actions to reduce reliance on ratings in the regulatory framework and make several recommendations that will be included in the Basel III rules.[25]

In the USA, the Dodd-Frank Wall Street Reform and Consumer Protection Act, (the Dodd-Frank Act)[26] has strengthened rules on CRAs. Among other things section 939A of the Dodd-Frank Act requires federal agencies to review how existing regulations rely on ratings and remove such references from their rules as appropriate. As a consequence, the Securities and Exchange Commission[27] (SEC) is currently exploring ways to reduce regulatory reliance on external credit ratings and replace them with alternative criteria.[28]

4. PROBLEM DEFINITION

The problems described in the following section can be grouped into six broad areas:

- Overreliance on external credit ratings leading to "cliff" effects[29] in capital markets;
- "Contagion effects of sovereign debt rating changes;
- Limited choice and competition in the credit rating market;
- Insufficient right of redress for users of ratings suffering losses due to an inaccurate rating issued by a CRA that infringes the CRA Regulation;
- Potentially undermined independence of CRAs due to conflicts of interest arising from the "issuer-pays" model, ownership structure and long tenure of the same CRA; and
- Insufficiently sound credit rating methodologies and processes.

These problems are largely interrelated and could reinforce each others' effects.

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23 G20 Seoul Summit leaders' Declaration, 11-12 November 2010. Available from: http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf.

24 G20, Toronto G20 summit declaration, 26-27 June 2010. Available from: http://www.g20.org/Documents/g20_declaration_en.pdf.

25 These included, for example, proposals to remove or reduce certain "cliff effects" related to ratings from the internal-ratings based (IRB) approach and standardised approach (SA). In particular, the Ratings and Securitisation (RS) group is now working on addressing adverse incentives and cliff effects arising from the use of ratings through: (i) the recalibration of risk weights for securitisation exposures under the ratings-based approach, including to reduce "cliff effects"; (ii) the review of the hierarchy of approaches in the securitisation framework with the aim of reducing the predominant role played by external ratings; and, (iii) the enhancement of internal assessment and due diligence requirements. Final proposals on these topics are expected to be completed in time for the September 2011 meeting of the Basel Committee.

26 Dodd-Frank Wall Street Reform and Consumer Protection Act, 29 June, 2010.

27 SEC Initiatives under New Regulatory Reform Law.

28 SEC Proposes First in Series of Rule Amendments to Remove References to Credit Ratings, 9 February 2011. Available from: http://www.sec.gov/rules/proposed/2011/33-9186.pdf.

29 "Cliff effects" are sudden actions that are triggered by a rating downgrade under a specific threshold, where downgrading a single security can have a disproportionate cascading effect.

While some of these issues, notably issue of overreliance and independence were already recognized when the CRA Regulation was first negotiated, the CRA Regulation did not fully address these issues but required the European Commission to monitor them and make an assessment by the end of 2012.[30]

[30] Article 39 (1) of the CRA Regulation.

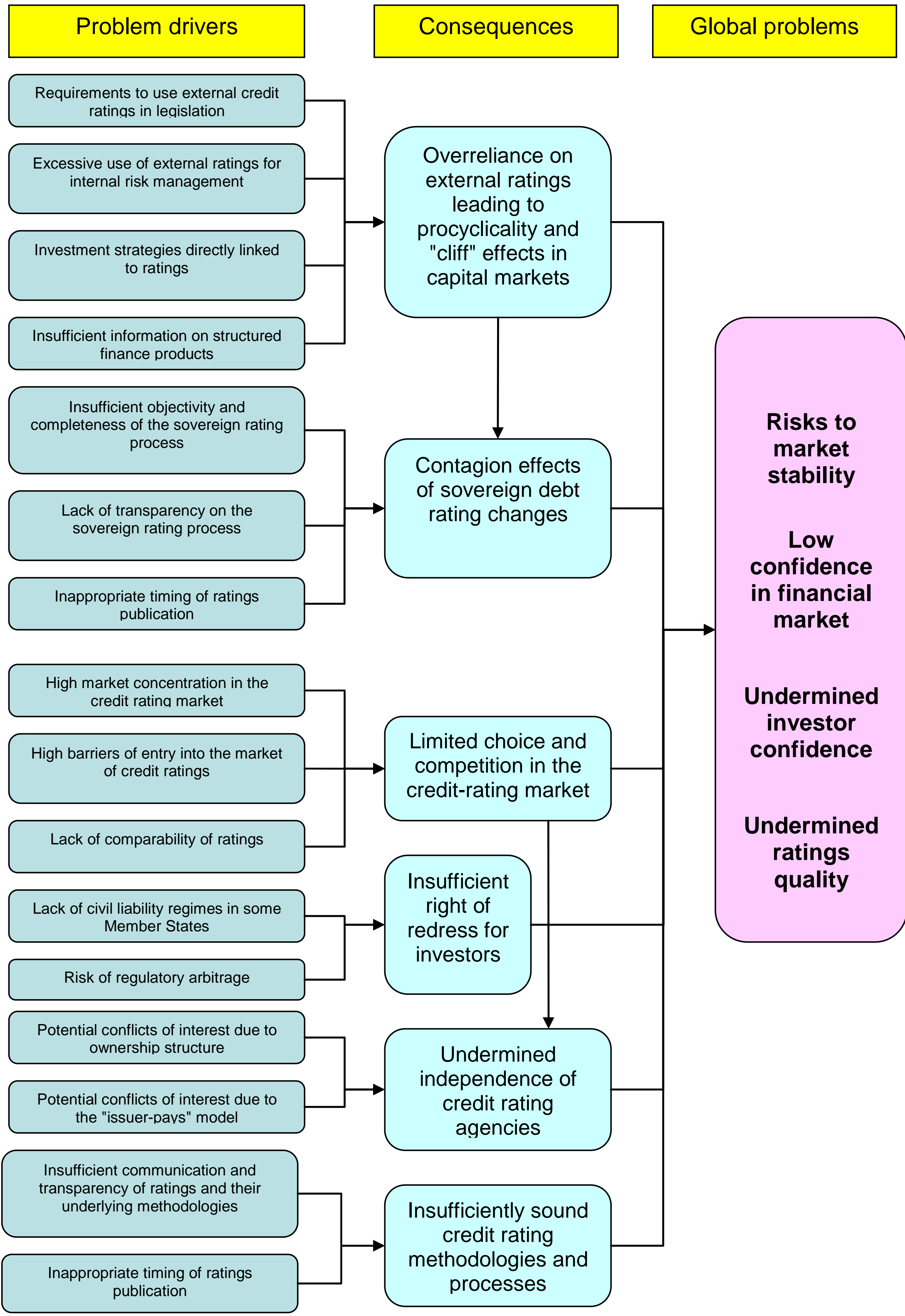

Figure 1. Problem tree

4.1. Overreliance on external credit ratings leading to "cliff" effects in capital markets

Under certain economic conditions, market participants' mechanistic and parallel reliance on external ratings leads to herd behaviour[31] and "cliff" effects. This can entail both upward market bubbles and downward market spirals which could affect market stability. This became evident during the current financial crisis when worsening economic forecasts put pressure on public finances. This, in turn, led to a downgrade of sovereign bonds[32] below a threshold causing simultaneous selling off of debt instruments[33] by many financial institutions and investors. Thus, overreliance on external ratings has exacerbated financial in-stability in individual countries, with negative effects on the European and global level.

Use of credit rating in the regulatory regimes

The current use of credit ratings in the regulatory regimes for banks, insurance undertakings and other financial institutions reinforces this overreliance and discourages financial firms from undertaking their own risk assessments and due diligence.

Reference to external ratings in regulatory capital frameworks of financial institutions may lead to sudden rises in capital requirements once a rating action occurs.[34] In reaction to a financial instrument's significant downgrade, many firms using a regulatory approach relying on external ratings may decide in parallel to sell off the downgraded instrument which may cause a downward price spiral with potential negative effects on financial stability.[35]

In the banking sector the use of external ratings is explicitly envisaged by the Capital Requirements Directive[36], which requires the use of external ratings for measuring capital requirements under the standardised approach.[37] [38] In the insurance sector, neither the existing framework of insurance[39] and reinsurance[40] directives (commonly referred to as "Solvency I")

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[31] Herd behaviour implies systematic and erroneous decision-making by a group. Intuitively, investors can be said to herd if they would have made an investment without knowing other investors' decisions, but refrain from making that investment when they learn that others have decided not to do so. See The Financial Cycle, Factors of Amplification and possible Policy Implications for Financial and Monetary Authorities, Banque de France, Bulletin No 95, November 2001, p.68. Available from: http://www.banque-france.fr/gb/publications/telechar/autres_telechar/fincyc95.pdf.

[32] Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis, Rabah Arezki, Bertrand Candelon, Amadou Sy, CESIFO Working Paper No. 3411, Category 7: Monetary Policy and International Finance, April 2011.

[33] See section 4.2. Contagion effect of sovereign debt ratings.

[34] There is evidence that credit ratings affect a firm's cost of capital specifically due to the regulations based on ratings. See Darren J. Kisgen Philip E. Strahan, Do regulations based on credit ratings affect a firm's cost of capital?, March 2009.

[35] There spillovers from the Sovereign to the Banks and Banks to Sovereigns, International Monetary Fund, Global Financial Stability Report, Sovereigns, Funding and Systemic Liquidity. October 2010, p. 4. Available from: http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf.

[36] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177/1, 30.6.2006).

[37] The standardised approach has received little research attention even though some estimates indicate that 30% of European banks have adopted it. Source: Patrick Van Roy, Credit Ratings and the Standardise Approach to Credit Risk in Basel II, p. 5. The European Central Bank, Working paper series No. 517, August 2005. Available from: http://www.ecb.int/pub/pdf/scpwps/ecbwp517.pdf.

[38] Articles 94, 96 Directive 2006/48/EC.

[39] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, OJ L 345/1, 19.12.2002. First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance OJ L 228,16.8.1973; Council Directive 78/473/EEC of 30 May 1978 on the coordination of laws, regulations and administrative provisions relating to Community co insurance OJ L151, 7.6.1978; Council Directive 87/344/EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses

nor the "Solvency II" Framework Directive[41], which has revised the existing solvency regime and introduced risk-oriented solvency requirements, contain any reference to external ratings. Such references may however be considered in the future implementing measures of the Solvency II framework directive in order to specify the standard formula.

Reliance on external ratings for (credit/market) risk management and investment decisions

Use of external ratings for (credit/market) risk management may lead to herd behaviour as a rating actions may trigger parallel reactions in many financial firms[42], all relying mechanistically and solely on external ratings, issued by a small number of credit rating agencies.[43]

Financial firms basing their investment decisions solely on external ratings without carrying out their own risk assessment may not have the necessary understanding of the financial instrument in which they invest. Furthermore, the publicly disclosed information about structured finance products is often insufficient for investors to adequately assess risks related to specific financial instruments and therefore forces them to rely on external ratings.

In a similar fashion investment policies and the mandates of portfolio and asset managers often make reference to external ratings when defining the minimum credit quality for a portfolio or performance benchmarks. Investors often require investment managers to adhere to minimum credit quality standards defined by external ratings.[44] This provides a relatively simple and transparent mechanism for investors to control and monitor the credit risk of the assets in which the manager invests. Even if the widespread use of ratings in investment policies, mandates and other commercial contracts is not a direct consequence of EU legislation, it may exacerbate the "cliff" effects associated with rating downgrades, where investment managers are obliged to sell off financial instruments no longer complying with the credit quality standards specified in their mandate or policy. The simultaneous sale of debt instruments triggered by a downgrade may result in losses to investors[45] and increase market

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insurance OJ L 185 4.7.1987, p.77; Second Council Directive 88/357/EEC of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services OJ L 172, 4.7.1988 p.1; Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance (third non life insurance Directive) OJ L 228, 11.8.1992.

40 Directive 2005/68EC of the European Parliament and of the Council of 16 November 2005 on reinsurance, OJ L 323/1, 9.12.2005.

41 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) , OJ L 335, 17.12.2009.

42 Credit institutions, investment firms, insurance and reinsurance undertakings, pension funds, investment managers.

43 Moody's (2001) describes three instances of rating-trigger-related "mutual assured destruction" during 2000–01: (1) collapse of Enron: in that case, trading and other financial agreements gave counterparties the right to demand cash collateral, and lenders the right to demand repayment of outstanding loans once Enron's credit rating declined below a certain level; (2) PG&E Corporation; (3) Southern California Edison Company. See IMF - Global Financial Stability Report - autumn 2010, p. 8. Available from: http://blogs.sciences-po.fr/recherche-predictions/files/2010/12/gfsr-201010-3-sovereign_ratings-imf-global-stability1.pdf.

44 Many investors have mandates limiting what they can invest in, and these are normally linked to ratings, so they will have a bucket allocated to triple-A securities, to double-A and so on. If they cannot fill those buckets, then they cannot fulfil their mandate. See Banking Supervision and Regulation - Economic Affairs Committee, Chapter 6: Ratings Agencies, section 167, Parliament UK. Available from: http://www.publications.parliament.uk/pa/ld200809/ldselect/ldeconaf/101/10109.htm.

45 The thousands of mortgage-related securities rated by Moody's in 2006, 83 % of those rated AAA were ultimately downgraded. The impact of these inflated ratings, and their subsequent mass downgrades, was far-reaching. CalPERS, on which one and a half million Californians rely for their pension and

volatility.[46] Another "cliff" effect may occur when debt instruments downgraded below a certain threshold are removed from bond market indices used as a benchmark for portfolios.

Other references to external ratings

There are also references to external ratings in Member States' laws and regulations which are not required by EU legislation. In June 2009, the Joint Forum[47] undertook a stock take of the use of ratings which showed the use of external credit ratings in the national legal orders of many EU Member States.[48]

Furthermore, the ECB uses credit ratings for the purpose of defining securities acceptable as collateral in market operations. The definition of eligible securities includes the requirement for the issuer to have a satisfactory credit rating from two or more of the leading credit rating agencies. This practice may induce banks to sell off securities once they lose their eligibility as collateral, which further reinforces "cliff effects". One could claim that, to a certain extent, this ECB policy also sends a wrong signal to the whole banking industry what an acceptable level on external reliance should be. However, the ECB stated in its contribution to the public consultation that it has started a process to enhance and develop further its internal capabilities to independently assess the creditworthiness of issuers for its own purposes. In this regard it should also be noted that the credit assessment framework of the Eurosystem is decided independently by the ECB Governing Council.

Also the European Financial Stability Facility (EFSF)[49] framework agreement[50] of 7 June 2010 between the EFSF and the "euro-area Member States" or "EFSF Shareholders" sets out detailed operating conditions of the EFSF that contain references to external ratings.[51] The European Financial Stability Mechanism will be replaced by a new instrument as of 2013, the European Stability Mechanism (ESM). The treaty establishing the ESM[52] does not contain any direct references to external ratings.

For more detailed information on references to ratings in EU Financial Regulation, see Annex VI. section 2.1.

4.2. Contagion effects of sovereign debt rating changes

Spillover and contagion effects

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health benefits, estimated it lost $1 billion. It is estimated that pensioners in Ohio lost about half a billion dollars. The direct effect of these mass credit downgrades on retirement savings nationwide is almost certainly in the tens of billions of dollars. As a result of the financial collapse more broadly, Americans' retirement savings saw losses of about $2 trillion. Information source: Official letter from US Senate (Al Franken and Roger F. Wicker, US Senators) to Chairman of SEC (Mary L. Schapiro) on the implementation of the Franken-Wicker amendment on assigned credit ratings and also other relevant policy measures, 14 September 2011.

46 Ibid Moody’s (2001).

47 The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors.

48 The Joint Forum, Stocktaking on the use of credit ratings, June 2009. Available from: http://www.bis.org/publ/joint22.pdf.

49 The EFSF is a "société anonyme" incorporated in Luxembourg.

50 http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf.

51 More particularly, point 2 (3) regarding issues of guarantees states that the EFSF may also request the Guarantors to issue Guarantees under this Agreement for other purposes which are closely-linked to an issue of Funding Instruments and which facilitates the obtaining and maintenance of a high quality rating for Funding Instruments issued by EFSF and efficient funding by EFSF.

52 Treaty establishing the European Stability Mechanism (ESM) signed on 11 July 2011, currently under ratification by the Eurozone Member States. http://www.efsf.europa.eu/attachments/esm_treaty_en.pdf.

The recent market developments have highlighted the magnitude of the potential impact of sovereign ratings which goes far beyond the immediate effects on the bond markets of the rated countries and can result in negative spillovers across markets and even across countries which have significant economic linkages. The multiple effects of sovereign ratings on financial markets can be described as follows:

- Firstly, sovereign debt ratings play a crucial role in determining a country's borrowing costs. Empirical evidence[53] shows that sovereign rating events have a statistically and economically significant effect on yield spreads.[54] It is worth observing that available research shows that there is asymmetry in market reactions, i.e. while there is a significant reaction of sovereign yield spreads (and particularly CDS spreads) to negative events, the reaction to positive events is much more muted.[55]

- Secondly, sovereign rating events may have spillover effects within the country across markets (from government bond markets to corporate bond markets to equity markets) with huge impact on the cost and access to external funding for wide range of entities (including public administrations, local governments and financial institutions). A sovereign rating is indeed one of the factors which heavily influences the assessment of the counterparty risk and serves often as a general benchmark for all other credit ratings for all the entities located in the country. Furthermore, the highest rating possible for most entities located in a country is often capped by the country's own rating.

  Multiple examples over the past year of a downgrade of a Member State immediately followed by a downgrade of financial institutions of that country illustrate the importance of a sovereign rating for ratings of financial institutions located in the country experiencing a rating change. An example of this relation between sovereign ratings and ratings of financial institutions can be illustrated by the recent downgrade of Portugal by Moody's on the 6th of July 2011 followed by a downgrade of four Portuguese financial institutions the following day. Another example is provided by the downgrade of Italy by Standard and Poor's on 20 September 2011 and by Moody's on 4 October 2011 which were followed a few days after by the downgrade of some of the major Italian financial and non-financial companies and local authorities.

- Finally, sovereign debt ratings may trigger contagion effects beyond the borders of the country directly affected by the rating event. Economic literature[56] demonstrates that the

[53] Sovereign downgrades have a negative impact on sovereign bond yield spreads and can have spillover effects as demonstrated by: Alfonso, Furceri, Gomes, "Credit ratings and the Euro Area Sovereign Debt crisis" University of Freiburg, 2011, p3. As an example, yield spread of Portugal sovereign debt rose on 2-year and 10-year sovereign bonds rose to respectively 8.971% and 8.766% after the downgrade by Moody's on 5 April 2011 from A3 to Baa1, following an earlier Moody's downgrade of 2 notches on 16 March 2011.

[54] The yield spread is the difference between the quoted rates of return on two different investments, usually of different credit quality. An analysis of spread developments around the time of rating announcements shows that sovereign downgrades are followed by rising sovereign spread changes as demonstrated in "European Economic Forecast, Spring 2011", Staff Working document, European Commission; Directorate General Economic and Financial Affairs, pag. 44-45.

[55] See Antonio Afonso, Davide Furceri, Pedro Gomes, Sovereign ratings and financial markets linkages. Application to European data. ECB paper n. 1347, June 2011. It is also interesting to observe that according to the Authors the reaction of CDS spreads to negative rating events has increased considerably after the beginning of the crisis (i.e. the 15.9.2008 – day of Lehman bankruptcy).

[56] Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, Sovereign Rating News and Financial Markets Spill-overs: Evidence from the European Debt Crisis, March 2011, WP/11/68. The paper demonstrates that sovereign downgrades have statistically and economically significant spill-over effects both across countries and financial markets. Their magnitude depends on the type of announcement, the specific country affected by the rating decision and the specific CRA that issued the

excessive prominence given to sovereign debt ratings by market actors, including financial institutions and institutional investors, generates cliff effects[57] within the economy of the downgraded or upgraded countries as well as in economically linked regions. Also in this context it has been shown that negative announcements have the most significant effects[58], particularly from lower rated countries to higher rated countries, with potential contagion of neighbouring countries.

Factors amplifying spill-over effects

Recent market developments show that negative spill over effects attached to sovereign rating changes are amplified by a series of factors ('drivers') which can exacerbate a situation of crisis and result in spreading financial instability across markets and countries. In view of the implications of sovereign ratings on the wider economy the hereafter described problems and drivers suggest the application of the precautionary principle.

The first problem driver behind the described spill-over effects relates to overreliance on external ratings, which was addressed in section 4.1. In the event of a sovereign downgrade, ratings-based rules[59], such as regulatory capital requirements and ECB collateral guidelines, can prompt automatic sell-off orders of sovereign debt, creating spill-over effects to the broader economy. The recent events affecting particularly the euro area sovereign debt markets provide a good illustration of these mechanisms.

Another factor which is relevant in amplifying contagion effects of sovereign ratings is the important degree of subjectivity of the sovereign rating processes and to some extent the lack of consistency of CRA's behaviour over time. Indeed recent research show a substantial increase of the 'arbitrary component' of the sovereign ratings over the recent years, particularly in 2009 and 2010[60], and point at the existence of subjective biases in favour or against the rated nations to (partly) explain the differences in sovereign ratings given by two of the major Rating Agencies.[61] This could be explained, inter alia, by the higher reputational risk attached to rating misspecification in a context of economic crisis and lack of investor's confidence which may lead CRAs to be 'keener' on lowering sovereign ratings (while CRAs could be keener to attribute higher ratings in boom times, when investor's trust tends to rise).[62] The lack of consistency of CRAs' behaviour can prompt market over (or under)reactions since the markets do not 'understand' sufficiently the message the Rating Agency is trying to communicate when it ventures an opinion on the future solvability of the country.

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rating. Furthermore, they find evidence that downgrades to near speculative grade ratings for relatively large economies such as Greece have a systematic spill-over effect.

[57] Cliff effects in this context are sudden actions that are triggered by a rating downgrade under a specific threshold. They may for instance occur if a specific sovereign debt is downgraded to non-investment grade and following this downgrade many investment managers have to sell off this instrument when it no longer corresponds to their investment policies or mandates.

[58] Ferreira and Gama demonstrate that sovereign rating downgrades are associated with an economically and statistically significant negative return spread in stock market of neighbourhood countries while upgrades abroad have no discernible impact. Furthermore they show that geographic distance is inversely related to the spillover impact. See Ferreira and Gama, Does sovereign debt ratings news spill over to international stock markets, Journal of Banking & Finance, 2007.

[59] Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis, March 2011, WP/11/68.

[60] See Gartner, Griesbach and Jung, PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies, Univerity St. Gallen, 2011.

[61] See S. Iyengar, Are Sovereign Credit Ratings objective and Transparent? IUP Journal of Financial Economics, 2010. The Author argues, comparing Moody's and S&P's sovereign ratings of 1995 with those of 2007, that: 1) there has been considerable increase in the average difference in the ratings provided by the two agencies; 2) the differences in their ratings are due to the subjective assessments of the countries by the two rating agencies.

[62] See Afonso and Gomes, Do fiscal imbalances deteriorate sovereign debt ratings?, ISEG, 2010

Moreover recent events showed that some rated countries have questioned the accuracy of sovereign ratings and have complained that possibly not all the available and up-to-date information being used and not all relevant scenarios being taken into account. This could reinforce the feeling that rating events are based more on subjective perceptions rather than objective indicators and parameters. Examples are provided by the cases of the downgrading by Standard and Poor's of Greek sovereign credit on 29 March 2011 and of the change by the same Rating Agency of the outlook for Italy from stable to negative on 21 May 2011. In both cases the Ministries of Finances of both Countries complained about the lack of accuracy of the rating agency. In particular in the first case Greek authorities complained about the lack of an adequate assessment of the latest European Council's decisions and, in the second case, Italian authorities criticized the worsening of the outlook without any justification due to changes in the fundamentals of the country and only on the basis of the subjective appreciation of a risk of "political gridlock[63]

Another problem driver specific to sovereign ratings is the lack of transparency on the sovereign rating process both in terms of insufficient disclosure of the methodology and of underlying assumptions[64] and in terms of inadequate communication with the issuers. Reasons for changing sovereign ratings are sometimes inadequately communicated and, despite the level of disclosure required by Article 10 of Regulation 1060/2009, often remain unclear to the public, which may trigger significant investor overreactions. Investors do not always have all the necessary information (on models, on underlying assumptions, on indicators, on the weight given to the different indicators) to fully decrypt the rationale behind the sovereign rating event. This in turn can strengthen the perception of the relevance of the subjective component of ratings and send out the wrong signals to the investors.

This is also applicable to the rated country's public authorities which do not always have sufficient understanding of the variables and methodologies used by the rating agency and cannot always check in advance the accuracy of the information on which the rating is based nor challenge, where appropriate, the conclusions of the rating agency. The current enforced notification period of 12 hours, appears to not be adequate for sovereigns to verify if the rating event is based on accurate and up-to-date data. This increases the risk of incorrect or outdated data not being timely removed before the rating process is finalised, which in turn can undermine the quality of the sovereign rating issued. An example of this problem is the downgrade of Greece and Spain by Moody's, three days and one day respectively before the Council meeting on the extension of the EFSF support package by 440€ billion on 11 March 2011, when it appeared that the information in the package under negotiation was not completely reflected in the rating process. Another example of the risks of incorrect data used for sovereign ratings by rating agencies was highlighted after the recent downgrade of the US in August 2011.[65]

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[63] See press releases of the Ministry of Finance of the Hellenic Republic on 29 March 2011 ("Press release on the downgrade of Greek sovereign credit by Standard and Poor's") and of the Italian Ministry of the Economy – Treasury on 21 May 2011 ("Tesoro: l'Italia rispetterà gli impegni presi").Other examples in that sense are provided by the four-notch downgrade of Portugal on 5 July 2011 by Moody's which unleashed strong criticism by, inter alia, the German Minister of Finance W. Schauble for not being substantiated by adequate analytical elements and by the downgrade of the USA by Standard and Poor's on 5 August 2011 which was heavily criticized by the US administration after Treasury officials had discovered that the rating agency's estimates of the government's discretionary spending was $2 trillion too high. See for instance Reuters, Obama officials attack S&P's credibility after downgrade, 6 August 2011, available at http://www.reuters.com/article/2011/08/06/usa-rating-sp-error-idUSN1E77500420110806.

[64] It should be noted that Regulation 1060/2009 on rating agencies has introduced transparency requirements for all types of ratings. However, there are no specific rules for sovereign ratings.

[65] The downgrade of the USA by Standard and Poor's on 5 August 2011; available at http://www.reuters.com/article/2011/08/06/usa-rating-sp-error-idUSN1E77500420110806.

Another problem driver is represented by the timing of ratings publication has proved to be not suitable for the specific relevance and potential impact of sovereign ratings on markets. Actually current practices of publishing sovereign ratings when markets are open, particularly when this happens just before markets close, entails the risk of stimulating market volatility.[66] This was the case, for instance, of the downgrade of Greece by Standard & Poor's on 27 April 2010, which occurred a few days before the adoption by the Council of the EU of the rescue package on 6 May 2010, which at the time of the decision of the Agency was still under negotiation.

Finally, CRAs have been criticised for lagging rather than leading the market and for not revising sovereign ratings in a timely manner.[67]

4.3. Limited choice of rating agencies and ratings for issuers and investors

The analysis of the structure of the market for rating services unveils a level of concentration which is significantly high (see Annex IV). This entails limited choice of rating services providers both for investors and issuers, the existence of economic rents for rating agencies and most likely higher prices. Furthermore, the market is characterised by relevant "reputational" barriers which can prevent new potential competitors to enter the market (for more information, see Annex VI. section 2.3). Moreover existing legislation on capital requirements further aggravates the problem creating additional obstacles to potential new actors. Indeed, ratings of new market entrants cannot always be used for regulatory capital purposes unless they are recognized as External Credit Assessment Institution (ECAI) by banking supervisors (see below).

For investors, beyond the issues mentioned above, the high market concentration emphasizes the problem of overreliance on the few international rating agencies.

High profit margins[68] of the existing CRAs and limited transparency of pricing suggest that there are risks of high pricing in the market of credit ratings.[69] Moreover the limited availability of service providers reduces the elasticity of the demand, i.e. issuers have limited possibilities to change their CRA if they are not satisfied with its performance. Furthermore, some segments of issuers, particularly SMEs or small sovereigns, might experience difficulty to obtain a rating as not all market segments are adequately covered by the existing rating agencies or ratings might be too expensive for these issuers. This can substantially limit capabilities of small and medium sized issuers to access capital markets.

Furthermore, as said above, competition is hampered by the existence of strong economies of scope and of scale and by the relevance of reputation in the market for credit ratings.

[66] Opening remarks by the chairman of the IMF, International Monetary Fund at the IMF High–Level Roundtable Washington DC, March 18, 2011. Available from: http://www.imf.org/external/np/speeches/2011/031811.htm.

[67] Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, Sovereign Rating News and Financial Markets Spill-overs: Evidence from the European Debt Crisis, March 2011, WP/11/68. The paper explains that rating agencies have been slow in reacting towards a potential EU sovereign crisis as very limited rating activities of European sovereigns were observed until October 2008. Since that date a large amount (of mainly negative) downgrades have occurred. See also P. Artus, Are the credit rating agencies' country ratings partly to blame for the public debt crisis?, Natixis Flash Economics, May 2010 which clearly shows through a comparison between CDS markets and ratings movements for Portugal, Spain, Greece and Ireland that rating changes follow financial market movements instead of preceding them.

[68] For example S&P reported an operational margin of 45 percent in 2010, McGraw Hill 2010 Annual Report, p. 24. Accessible from: http://www.mcgraw-hill.com/about/annual_report/ar2010.pdf.

[69] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, 2007, p100. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821.

Moreover ratings from newly registered CRAs can face restricted uptake by the market also because they cannot be used for regulatory capital purposes if they have not been recognised as External Credit Assessment Institution (ECAI) by banking supervisory authorities according to Article 81(2) in connection with Annex VI, part 2 of Directive 2006/48.[70] As shown in Annex V, only 3 CRAs have been recognised as eligible ECAI from the majority of national supervisors while all other CRAs have obtained ECAI status in only a very limited number of Member States,[71] thus limiting the choice for issuers and investors of CRAs whose ratings can be used for regulatory purposes.[72] Measures to address this issue have been adopted in the proposal for CRD IV.[73]

Another factor hindering competition is the absence of a standardized rating scale which can be particularly detrimental for small CRAs' ratings lacking a well established international status.

A further barrier to entry can be represented by the fact that some issuers and investors are sometimes unaware of all the existing providers of rating services. However, it should be noted that the CRA Regulation partially addresses this problem by requiring registration[74] of all rating agencies and subsequent publication on the ESMA website which should improve the visibility and credibility of new rating agencies establishing themselves on the EU market. A list of authorized CRAs (see Annex IV section 1) has been published in the 'Europa' website since June 2011 and is now available on the ESMA website[75] since the latter took over all the competences and duties related to the supervision of CRAs on 1 July 2011.

4.4. Insufficient right of redress for investors

Currently, the CRA Regulation does not establish a specific civil liability regime itself.[76] Investors' claims against CRAs are legally difficult to treat under the predominant issuer-pays model, where investors do not have a contractual relationship with the CRA (contrary to other financial actors such as banks, insurance companies which usually have a contractual relationship with their clients, for instance, an insurance contract, investment advice contract etc). Consequently, an investor suffering a loss due to a flawed rating, in breach of the CRA Regulation, can not base claims for compensation directly[77] on contract law. Whether and under what conditions an investor can claim compensation based on the law of tort or delict varies largely according to the legal orders of Member States.[78] Often, liability of CRAs vis-à-vis investors outside contractual relationships is subject to restrictive conditions so that in

70 Article 2 (3) of the CRA Regulation states that registration is only a precondition to obtain ECAI status under Directive 2006/48/EC. According to Article 81 (2) in connection with Annex VI Part 2, 2.1 of Directive 2006/48 banking supervisory authorities shall only recognize an ECAI as eligible for capital requirement purposes if its ratings are recognised in the market as credible and reliable which may be implied by a relevant market share of the ECAI.

71 All other CRAs have obtained ECAI status in 6 or less Member States in July 2010.

72 This is particularly relevant for issuers aiming to sell their debt instruments in an international context, requiring an ECAI status in all Member States.

73 The legislative proposal on Capital Requirement Directive IV was adopted by the Commission on 20 July 2011. ECAI statute is addressed in Article 130 (2) and article 262 (2) of COM (456), which outlines that all registered or certified CRAs under the CRA regulation are eligible ECAIs.

74 Article 14 of the CRA Regulation.

75 The list is available at http://www.esma.europa.eu/popup2.php?id=7692.

76 Nerveless, Recital 69 of the CRA Regulation states that any claim against a CRA in relation to any infringement of the provisions of this Regulation should be made in accordance with the applicable national law on civil liability.

77 In Germany there is discussion regarding whether the contract between the CRA and the issuer could somehow encompass the investors ("Vertrag mit Schutzwirkung für Dritte"). However, it is unclear whether a court would accept this reasoning.

78 For more detailed information see Annex VI, section 2.4.

practice investors do not seem to have an effective right of redress. This is confirmed by the very limited case law in EU Member States on CRAs' civil liability towards investors. Also, the fact that the conditions under which investors can claim damage against CRAs are often either not very clear or left to courts' discretion may in practice prevent investors from claiming damage even in cases of clear infringements and gross negligence.

It is not satisfactory that it is often difficult for investors to claim damage from CRAs. This is not consistent with the general principle of civil law that each person infringing its obligations towards another person acting negligently or with intent, thereby causing damage to the other person, should be held liable. Investors have an evident interest in good quality ratings as they use ratings as a basis for investment decisions. This implies that CRAs have an obligation of due care towards investors as specified in many requirements of the CRA Regulation.[79]

Differences between Member States' civil liabilities regimes applicable to CRAs lead to different levels of protection for investors and could even incentivise forum shopping whereby CRAs try to achieve the application of the law of a Member State where civil liability for infringements of the CRA Regulation is less likely.

The results of ESMA Survey on Member States' civil legal orders in respect of provisions on which investors could base claims against CRAs having infringed the CRA Regulation can be found in Annex VI. section 2.4. This shows that in some Member States, including Poland and Sweden, such civil claims would not be possible.

4.5. Potential conflicts of interest and other issues linked to credit rating methodologies and processes

Conflicts of interest due to remuneration models

One of the sources of potential conflict of interest is the prevailing remuneration model under which an issuer solicits and pays a CRA to rate its own debt instruments ("issuer-pays model"). There is empirical evidence that large issuers of structured finance instruments received more favourable ratings than smaller issuers during the booming period leading to the financial crisis which can be explained by the fact that especially larger issuers contributing significantly to the income of a CRA, used their bargaining power to achieve higher ratings (which were not justified).[80] In fact under the issuer-pays model CRAs have a financial incentive to generate business from rated issuers, risking the issuance of overinflated ratings in order to increase or keep business.

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[79] E.g. the obligation of a CRA to take all necessary measures to ensure that the information it uses in assigning a credit rating is of sufficient quality (Art. 8 (2) CRA Regulation) or the obligation to monitor and regularly update its credit ratings (Art. 8 (5) CRA Regulation) are obviously in the interest of investors. Breaching these obligations may lead to faulty ratings and could cause damage to investors who have based investment decisions on these ratings.

[80] Jie (Jack) He, Jun 'QJ' Qian, Philip E. Strahan; Are all ratings created equal? The impact of issuer size on the pricing of mortgage-backed securities; July 2011. Available from: https://www2.bc.edu/~strahan/Ratings-July2011.pdf. The authors show that structured finance issues of large issuers were better rated than those of smaller issuers of comparable quality during the financial crisis. This shows the conflict of interests of the issuer pays model (large issuers can use their bargaining power to achieve higher ratings which are not justified). The paper concludes that " there is a robust relation between issuer size and the market prices of mortgage-backed securities conditional on ratings, and conflicts between the interests of issuers (who pay for ratings) versus those of investors (who consume ratings) may explain this relationship".

The CRA Regulation introduced some provisions[81] to mitigate conflicts of interests related to the issuer-pays model. These provisions aim at mitigating conflicts of interests with regard to the issuer-pays model by requiring transparency and disconnecting the interest of the staff involved in the rating activity from the remuneration paid by the rated entity. In addition, the CRA Regulation requires staff to regularly rotate within the CRA so that analysts only deal with a specific entity for a limited time. However, these measures do not fully address the conflicts of interest due to the issuer pays model. An important issuer may decide to be rated on a continuous basis by his "preferred CRA" which in turn creates an incentive for this CRA to favour ratings of this issuer contributing significantly to its income. Even if the individual rating analyst does not profit directly from the continued business relationship to an issuer, the CRA as an organisation does. Increased transparency does not help as long as the issuer pays model applies on such a broad basis, so that it is difficult for investors to find a CRA whose remuneration model is less conflicted. Also the CRA Regulation acknowledged that further action may be needed to address conflicts of interest regarding the issuer-pays model by mandating the Commission to assess the appropriateness of this remuneration model by end of 2012.[82]

Other alternative payment models are the "investor/subscriber-pays" and the "public utility/government" model. Neither of these remuneration models is however free from conflicts of interest. [83]

The importance of reputation in rating business has also a "lock-in effect"[84] whereby issuers remain with the same CRA for a long period. This is due to the fact that if an issuer considers switching a rating agency, it would create a suspicion among investors and can lower investors' trust in issuers. This lock-in effect is at its strongest when issuers consider changing to new market entrants with a shorter track record.

Conflicts of interest due to shareholder structure

As regards conflicts of interests due to the shareholder structure it could bring a CRA's independence into question when a CRA rates its controlling shareholders. It is also problematic if shareholders controlling a CRA own or invest in products rated by the CRA they control or the same group of investors have significant stakes in more than one large CRA, as they may have an incentive to influence the rating in their own interest. Finally, the fact that an undertaking linked to a credit rating agency provides consultancy services to an entity which is later rated by that credit rating agency raises concerns.

Lack of transparency of rating methodologies

The lack of transparency of rating methodologies contributes to further uncertainty in the market and thus has an important role for market stability. Current rules on methodologies only require disclosure of underlying assumptions for structured finance products, creating varying degrees of transparency for different asset classes. In addition, investors are not always well aware of the reasons for changes of methodologies and their impact on subsequently issued or revised ratings. This could cause a risk of disruption in the case that a revised methodology is misunderstood.

[81] CRAs have to disclose to the public the names of the rated entities from which they receive more than 5 % of their annual income (Art 6 (2) in conjunction with Annex I Section B 2). Rating analysts may not be involved in any negotiation regarding fees with a rated entity and their remuneration shall not depend on the remuneration received from the rated entity (Art. 7 (2), (5) of the CRA Regulation). CRA staff has to rotate regularly, see Article 7 (4) in connection with Annex I, C, 8.

[82] See Article 39 (1) of the CRA Regulation.

[83] See Annex VI 2.5.2. and 2.5.3.

[84] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, 2007, p80-83. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821.

Pre-notification of ratings to issuers

Recent events have also raised an issue of the timing of publication of ratings. There is a question if a rated issuer is properly informed in advance of the rating publication. The current CRA Regulation requires that CRAs communicate 12 hours[85] in advance of the publication of a rating and the principle grounds on which a rating is based. In practice, issuers find that if the time period includes out of office hours (for example, overnight, public holidays) there is little time to check potentially complex data and draw the attention of the CRA to factual errors.

4.6. The baseline scenario: how would the problem evolve without EU action?

Without coordinated EU action, the problems in the five main policy areas would be unlikely to be resolved in spite of the CRA Regulation and ESMA's role as supervisor for CRAs since 1 July 2011.

If sectoral financial legislation in the EU remains unchanged, many financial institutions would use credit ratings to calculate regulatory capital in a mechanistic fashion and would solely base their internal risk management on credit ratings. Such overreliance means that investors would continue to react simultaneously to downgrades, maintaining herd behaviour and causing the "cliff" effect of disorderly markets with sudden price corrections and contagion effects.

Insufficient transparency would continue to exist especially in the area of sovereign debt ratings. Governments would have limited time to assess underlying data on which ratings are based and determine if all relevant information has been taken into account. In addition, rating agencies could continue to issue sovereign ratings at particularly sensitive times during trading, i.e. immediately ahead of auctions, during the syndication process or just before the close of business of European trading venues. Furthermore, investors would continue to have a limited explanation on rating changes and might continue to act on the basis of insufficient understanding of sovereign rating. In combination with the problem of overreliance, the risks of further spill-over effects and market disorder linked to sovereign downgrades would continue to exist. Consequently, risks undermining market stability in EU financial markets would remain. Furthermore, funding costs of Sovereigns could continue to be affected by market reactions on insufficiently transparent sovereign rating changes.

In the absence of EU-level action, the current structure of the CRA market would be unlikely to change quickly.

Over time more small and medium rating agencies are expected to register under the CRA Regulation and will start operating with an EU license offering alternative credit opinions to investors. However, new market entrants will most likely continue to have difficulties to gain reputation even though the registration requirement of the CRA Regulation may have improved the situation. Furthermore, these new entrants are expected to remain niche players, offering a service with is not comparable in terms of rated instruments, geographic reach and reputation, with the dominant market players. It is possible that over a period of 5 to 10 years one of the new market entrants could evolve towards a more sizable new market player.

Differences between Member States' civil liability regimes applicable to CRAs could result in forum shopping, whereby CRAs chose jurisdictions where civil liability for infringements of the CRA Regulation is less likely. Despite a common EU regulatory framework for CRAs this situation may result in diverse levels of protection for investors. While it could be argued that the CRA Regulation, which has empowered ESMA to impose sanctions on CRAs for having

[85] Annex I D I (3) of the CRA Regulation.

infringed the Regulation, already provides sufficient incentives to CRAs to comply with the rules, this does not improve the situation for investors. The possibility of sanctioning CRAs is not a substitute for an efficient right of redress for investors. Sanctions imposed in the public interest do not compensate investors for their losses; a functioning sanctioning system and efficient right of redress for investors allowing for private enforcement are complementary instruments.

Despite the current CRA Regulation's provisions aimed at reducing conflicts of interest some conflicts of interest in the CRA market mainly due to the issuer-pays model would remain. Since under the issuer-pays model CRAs have a financial interest in generating business from rated firms, there is still the risk that firms pay for higher ratings. The potential conflicts of interest imply threats to financial stability, as well as for investor protection and market integrity.[86]

4.7. Subsidiarity

According to the principle of subsidiarity (Article 5.3 of the TEU), EU level-action should be taken only when the aims envisaged cannot be achieved sufficiently by Member States alone and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the EU. The preceding analysis shows that although all the problems outlined above have important implications for individual Member States, their overall impact can only be fully perceived in a cross-border context. This is because ratings can be issued in one country for financial instruments issued in another, so that action taken on a national level might not have any effect, as ratings could continue to be issued and used if they were produced in a different EU or even third country jurisdictions. As a result, national responses to credit rating issuance risk being circumvented or ineffective without EU-level action. Therefore any further actions in the field of CRAs can best be achieved by a common effort. Accordingly, EU action appears appropriate in light of the principle of subsidiarity.

[86] Orderly markets usually do not have volatile price swings and prices are competitive, reflecting the true value of the good or service.

5. OBJECTIVES

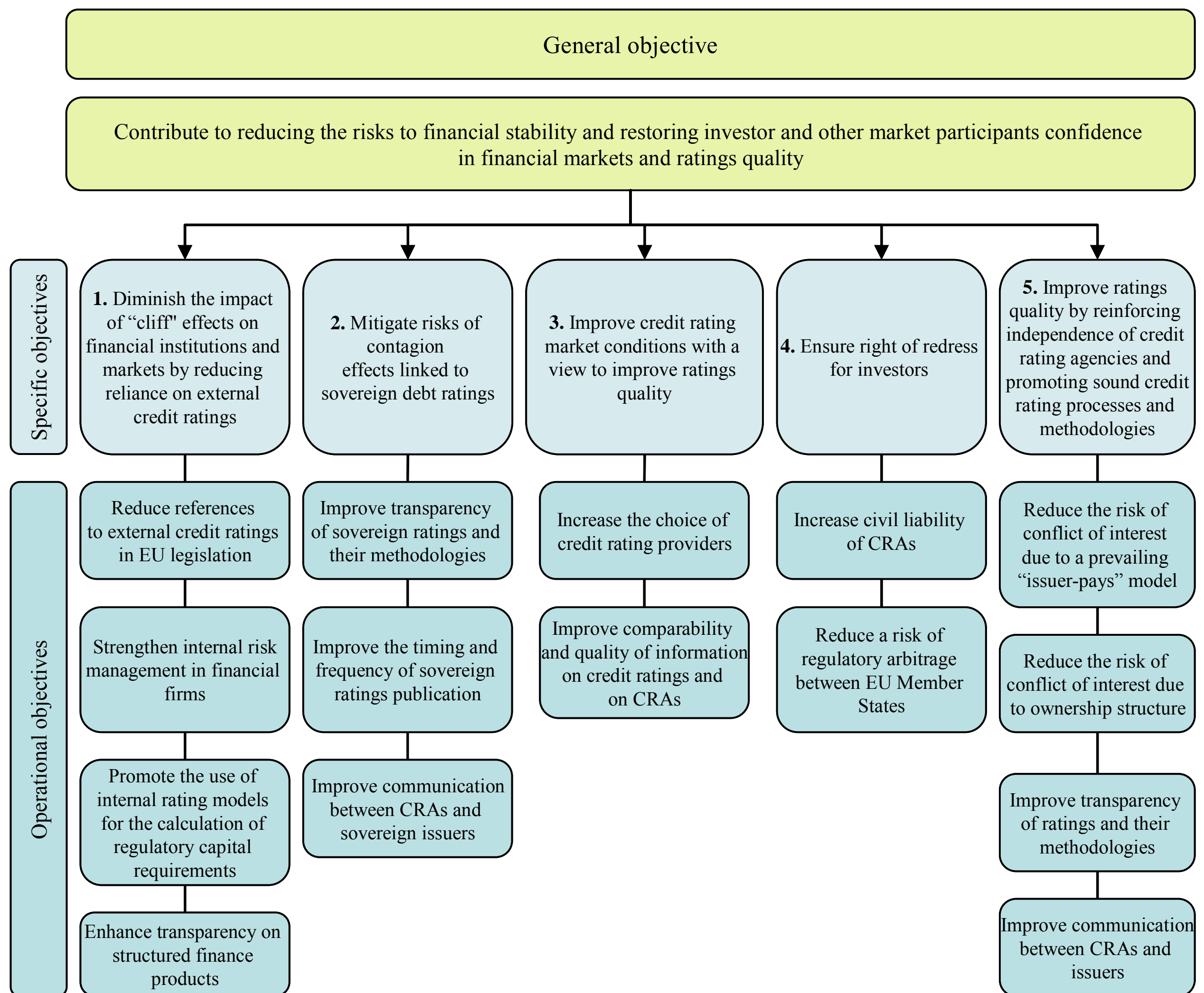

Figure 2. Objectives

The identified objectives are coherent with the EU's fundamental goals of promoting harmonious development of economic activities, a high degree of competitiveness, and a high level of consumer protection, including the safety of citizens' economic interests (Article 169 TFEU).

6. IDENTIFICATION AND ANALYSIS OF POLICY OPTIONS

This section presents the policy options for each objective, provides analysis of comparative advantages and disadvantages of different option in order to achieve these objectives (section 5). Sections 6.1 to section 6.5 deal with specific objectives 1 to 5 respectively.

An analysis in a table format in each section is made against the following criteria:

(1) impact on stakeholders, which include investors, issuers, financial companies, credit ratings agencies, sovereigns and regulators.

(2) effectiveness (the extent to which the option is likely to fulfil the objectives formulated in section 5).

(3) cost-effectiveness (the extent to which the objectives are likely to be met having considered the costs of implementing the option).

We use the following scoring system when presenting impacts on stakeholders, efficiency and effectiveness: magnitude of impact compared to the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; +/– both positive and negative ≈ marginal/neutral; ? uncertain; n.a. not applicable.

The presented policy options are not necessarily mutually exclusive, but also can be complementary. In the latter case, there are two or more preferred options to deal with a specific objective.

In the tables presenting the policy options "financial firms" are understood as credit institutions, investment firms, insurance, assurance and reinsurance undertakings, undertakings for collective investment in transferable securities (UCITS) and institutions for occupational retirement provision.

A more extensive description of policy options can be found in Annex VII. The analysis of the impact of these options on different stakeholder groups is given in Annex VIII an assessment of compliance costs and administrative burden is provided in Annex XII.

6.1. Policy options to reduce reliance on external credit ratings

Policy options
1. No policy change
2. Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes
3. Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating
4. Improve disclosure requirements for issuers of structured finance products on an ongoing basis

These options are not mutually exclusive. Options 2 and 4 can be combined with each other.

Option 1 – No policy change

Taking no policy action raises the probability that market players would continue to rely heavily on external credit ratings and fail to carry out sufficient due diligence, increasing the risk of market instability.

At the international level, the Basel Committee (BCBS) is undertaking work to reduce reliance on ratings in its rules. The Working Group on Liquidity will seek to reduce the importance of ratings as a criterion for defining liquid assets. This would increase the importance of alternative criteria before the liquidity requirement becomes binding in 2015.[87] The Ratings and Securitisation Working Group has already developed certain language to ensure better due diligence vis-à-vis credit risk. This forms part of the Basel III package. The work of the Ratings and Securitisation Working Group is planned to be finalised by the end of 2011. These requirements would have to be implemented into the sectoral EU legislation.

However, this option has shortcomings. First, Basel essentially deals with capital requirements for banks, meaning that other financial sectors would remain not addressed if no action were to be taken at the EU level. Second, also as far as banks are concerned the current situation leaves scope for the continued risk of procyclicality and cliff-effects in capital markets. It is unclear whether eventual requirements from other sources such as Basel will be sufficient to reduce overreliance on external credit ratings, and when they would be implemented by EU Member States. Third, making no policy change could potentially aggravate the consequences of the currently on-going euro area sovereign debt crisis and

[87] See Section 4.6. The baseline scenario: how would the problem evolve without EU action?

result in a heavy burden on taxpayers bearing the risk of rescuing failing systemically[88] important institutions.[89]

Option 2 – Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes

Remaining references to external ratings in sectoral EU financial regulation (see Annex VI section 2.1), including the guidelines from the European Supervisory Authorities[90], shall be addressed in the forthcoming reviews of these acts. Subject to separate impact assessments, these references would be removed, substantially reduced or replaced by other criteria to measure the creditworthiness of a rated instrument or an issuer. The criteria to be chosen may differ for each specific sector in order to take into consideration the specificities surrounding each category of financial actors. This approach would also be in line with the approach followed in the US (e.g., see Annex III. Section 6 which includes changes proposed by the US SEC, but also by other US regulatory bodies).

It should also be made sure that references to external ratings are avoided to the extent possible in any future EU legislation including technical standards and guidelines of the European Supervisory Authorities; concerning this issue a clear obligation would be introduced in EU regulation for European Supervisory Authorities to consider other solutions than pure reliance on ratings.

Moreover, it should be acknowledged that there will be a degree of voluntary reliance on ratings by small and individual investors which cannot be addressed by regulatory measures. Nevertheless, automatic and mechanical reliance on external credit ratings by regulated financial firms could be reduced.

Most responses to the public consultation from respondents in several categories, including industry associations, governments and regulators and rating agencies favoured a requirement for firms to conduct their own due diligence without relying exclusively on ratings.

Require all financial firms to strengthen their internal risk management

Firstly, the financial firms (credit institutions, investment firms, insurance and reinsurance) with material and complex[91] credit risk exposures would be required to strengthen their internal risk assessment by developing and using internal rating models.

The advantages of this sub-option compared to option 1 are as follows. As this option is in line with FSB principle III.2.a,[92] it would ensure coherence at international level. Furthermore,

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[88] Banks, insurance companies and pension funds continue to be perceived as key "systemic" institutions in many financial systems post-crisis. See Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations—Background Paper, Report to the G-20 Finance Ministers and Central Bank Governors, prepared by FSB, IMF, Bank for International Settlements, October 2009. Available from: http://www.imf.org/external/np/g20/pdf/100109a.pdf.

[89] See Annex VI Problem definition – background and technical details, figure 9. Cumulated financial sector stabilisation operations and their impact on government debt and contingent liabilities (2008-10).

[90] See Annex VI, section 2.1, Money market funds.

[91] A good proxy for large or complex exposures is exposures of "large or sophisticated institutions" for a sectoral legislation where entities are mainly exposed to credit risk (e.g. banking sector). This would also allow applying the proportionality principle in sectors where credit risk is usually not the predominant risk of large or sophisticated entities (e.g. insurers). Finally, this would also capture the pending developments on complex exposures such as securitisation that are being discussed in Basel.

it would address the second shortcoming of option 1, as the development and use of internal rating models would enhance the capacity for internal credit assessment of firms with material and complex credit risk exposures. It would meet the third operational objective and would overall contribute to the specific objective of diminishing the impact of "cliff" effects on financial institutions and markets by reducing reliance on external credit ratings. The internal rating models would contribute to ensuring that credit risks are adequately managed. It would partially address the first and third shortcomings of option 1, as a requirement to develop and use internal rating models for all credit institutions, investment firms, insurance and reinsurance undertakings (firms) with material and complex credit risk exposures at the EU level should give a greater degree of confidence in financial institutions for market participants.

However, also this sub-option has disadvantages. First, although the ongoing costs associated with this sub-option would be proportional to each individual financial firm, the total ongoing costs for relevant financial sectors could be substantial. In addition, a model where every financial institution performs its own rating analysis does not guarantee a better quality and transparency of ratings. A system of internal ratings can prove beneficial for the macro-financial stability only if internal rating methodologies are carefully and accurately reviewed and approved by a competent authority. The need to validate internal rating methodologies would clearly create an additional burden for CRAs supervisors. Second, since the standardised approaches relying on external credit ratings would continue to be authorized for small institutions or institutions whose exposure to credit risk is less material or less complex (for which the development of internal models would be disproportionate), such institutions would still be vulnerable to abrupt ratings changes and exposed to the higher market risk compared to those with internal credit assessments. Furthermore, like option 1, no policy change for small institutions could result in the need to rescue failing institutions and, consequently increase risks to taxpayers.

Nevertheless, most respondents to the public consultation favoured this option as they felt that financial institutions and all holders of securities – particularly large institutions – should understand the risks associated with their exposures. They should therefore be subject to rigorous due diligence standards and face financial and regulatory incentives to meet them.

The financial firms (credit institutions, investment firms, insurance and reinsurance undertakings, asset managers and investment funds) would be required to strengthen their own internal risk management for investment decisions.

This sub-option has a number of advantages. Firstly it would go towards reducing the risk of overreliance (FSB principle II)[93] and III.3.a.[94] Second, it would meet the second operational

[92] Larger, more sophisticated banks within each jurisdiction should be expected to assess the credit risk of everything they hold (either outright or as collateral), whether it is for investment or for trading purposes. FSB Report on Principles for Reducing Reliance on CRA Ratings, 27/10/2010. Available from: http://www.financialstabilityboard.org/publications/r_101027.pdf.

[93] Reducing market reliance on CRA ratings: banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA ratings. FSB Report on Principles for Reducing Reliance on CRA Ratings, 27/10/2010. Available from: http://www.financialstabilityboard.org/publications/r_101027.pdf.

[94] Investment managers should conduct risk analysis commensurate with the complexity and other characteristics of the investment and the materiality of their exposure, or refrain from such investments. They should publicly disclose information about their risk management approach, including their credit

objective and would overall contribute to the specific objective of reducing reliance on external credit ratings and mitigating the risk of cliff-effects. The downgrades would no longer necessarily lead to immediate sell-offs. In case of asset managers and investment funds, the end-investors would justifiably expect their appointed investment managers to exercise judgement in their investment decisions, rather than allowing rating changes dictate selling or buying decisions without due consideration. Investment managers would also be required to disclose their investment policies, including their approach to credit assessment, and seek regular management review. Third, since this option would apply to all financial firms (credit institutions, investment firms, insurance and reinsurance undertakings and asset managers and investment funds), it should enhance overall investor confidence in these markets and contribute effectively to financial stability.

One disadvantage of this option is the compliance cost for firms with internal risk management, which would include, for example, legal advice, access to capital market information sources and a framework of technologies to manage internal risks. On the other hand, ongoing costs would be moderate as many firms already have in place their own risk management systems. A second disadvantage is the uncertainty of whether it is possible to impose such restrictions on an investment mandate that is a commercial agreement between two parties. Great care would have to be taken in considering any rules in this area, as there could be a significant impact on smaller investors that do not have the resources to perform all their research internally. In addition, it is uncertain whether risk assessment performed by asset managers would be unbiased and free of conflicts of interest. Finally, this option has a strong cost element: requiring a multitude of market participants to duplicate the process of information gathering and information assessment would multiply the associated costs and thereby reduce the efficiency of financial intermediation at large.

Promote the use of internal rating models for the calculation of regulatory capital requirements

This sub-option has the advantage over option 1 that it would help to reduce reliance on external credit ratings in the calculation of the regulatory capital requirements. Credit institutions, investment firms, insurance and reinsurance undertakings using the "standard approach"[95] based on external ratings for calculating their regulatory capital requirements, would be required to assess if the inherent credit risk of an exposure is significantly higher than the one corresponding to the capital requirement assigned under the "standard approach" based on external ratings (or the absence thereof).

Furthermore, the credit institutions, investment firms, insurance and reinsurance undertakings would also be required to reflect the higher degree of credit risk in the evaluation of their overall capital adequacy. This implies that these firms would have to check the quality of the rating assessments they use in the standardised approach and, if the outcome of the analysis is negative, would have to deviate from that rating assessment.

Moreover, all credit institutions, investment firms, insurance and reinsurance undertakings would be treated equally and apply the same rules regardless of their size or level of risk exposure. This would contribute to improving investor confidence in financial markets and would mitigate the risk of cliff-effects on financial institutions and markets.

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assessment processes. FSB Report on Principles for Reducing Reliance on CRA Ratings, 27/10/2010. Available from: http://www.financialstabilityboard.org/publications/r_101027.pdf.

[95] "Standardised approach" for credit institutions (banks) and "standard approach" for (re) insurers.

One disadvantage of this option is the cost of compliance and administrative burden on relevant financial sectors as a whole. However, it could be argued that the cost would be proportional with respect to the individual financial firms.

Option 3 – Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating if available

This option has a number of advantages over option 1. First, requiring credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating issued by different CRAs would improve the accuracy of capital requirement calculations as the calculation would be based on more opinions.[96] It may also possibly mitigate to some extent "cliff" effects since the effect of a significant downgrade by one CRA may be reduced by the fact that financial firms would also take into account ratings of other CRAs.

However, option 3 also has a number of risks and disadvantages. Some respondents to the public consultation argued that certain types of structured finance instruments and covered bonds are frequently only rated by one CRA and this proposal would therefore have only a limited impact on markets. In order to compensate for this, a minimum of two credit ratings for structured finance instruments could be required. Furthermore, the requirement to use more than one rating could also negatively affect competition: investors would most likely look for ratings available from the existing large CRAs which would be favoured over small CRAs with limited availability of ratings unless the rotation of CRAs was introduced. Moreover, the potential benefits of this individual option on reducing overreliance are likely to be limited since the ratings issued by different CRAs, with regard to one issuer or instrument, tend to be similar.[97] However, the requirement for two independent ratings would likely increase the quality of ratings of those instruments which require special expertise, such as in the case of structured finance instruments.

Option 4 – Improve disclosure requirements for issuers of structured finance products on an ongoing basis

This option would provide investors on an ongoing basis with information on structured finance instrument, and in particular information on the performance of the underlying asset pool. This would enable financial firms and institutional investors to conduct own due diligence and assess the credit/market risk of a structured finance instrument by themselves and, as a consequence, reduce their reliance on external ratings. Additionally, other credit rating agencies (not mandated by the issuer) would be in a position to provide unsolicited ratings based on publicly available information.

Many responses to the public consultation favoured disclosure of information on structured finance instruments to all market participants as they felt disclosure under the current framework was not sufficient and additional disclosure would enhance their ability to understand ratings and conduct their own assessments and due diligence.

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[96] The Basel II rules already allow (but do not require) the use of more than one rating within the capital determination process, even though only one is ultimately used to set risk weights: If there are two assessments by ECAIs chosen by a bank that map two different risk weights, the higher risk weight will be applied. If there are three or more assessments, the determination of risk weights should refer to the assessments corresponding to the two lowest risk weights, with the higher of the two then applied.

[97] According to a 2006 report by the French AMF, even where ratings for a given issuer differ between CRAs, the difference is typically just one notch. AMF 2006 Report on rating agencies, Part II, Fund management rating, January 2007. Available at: http://www.amf-france.org/documents/general/7641_1.pdf.

According to Article 11 and Annex VIII of the Commission Implementing Regulation of the Prospectus Directive[98] issuers of asset-backed securities have to disclose information on the securities, the underlying assets, structure and cash flow of the transaction. However, such disclosure is only mandatory when asset backed securities are offered to the public or admitted to trading on a regulated market, while post issuance reporting is voluntary.[99]

This option would entail some costs for the issuers of structured finance instruments being required to disclose existing information on structured finance instruments on an ongoing basis. Moreover, the impact on reducing overreliance as such could be limited by the capacity of investors to risk assess these complex financial instruments by themselves.

The summary of the analysis of different options to achieve specific objective 1 (diminish the impact of “cliff" effects on financial institutions and markets by reducing reliance on external

credit ratings) is presented in the table below. The analysis of the impact of these options on different stakeholder groups is given in Annex VIII.

	Effectiveness	**Efficiency**
Option 1 (baseline)	*n.a.*	*n.a.*
Option 2 **(Reduce reliance on external ratings by promoting the use of alternative credit assessment models)**	*(++) would reduce overreliance and cliff effects;Would improve quality of investment decisions and make herding behaviour and investment bubbles less probable.* *Financial firms with material credit risk would be required to develop and use internal models to calculate capital requirements. This would considerably reduce overreliance on external ratings and reduce cliff effects.* *However, the effectiveness would be limited if there is a high correlation between internal and external ratings and/or re-assessments do not lead to deviation from external rating.*	*(+) increased costs for financial firms. However considered to be cost effective given the benefits for firms and financial stability.*
Option 3 **(Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating, if available)**	*(+/0) An effect of reducing reliance is likely to be limited due to converging ratings* *(-) potentially negative impact on competition in the market as investors would most probably choose for another large existing CRA.*	*(-) limited effect on overreliance combined with increased compliance costs for market participants to search and use available ratings that are not currently obliged to use more than one rating leads to a conclusion that it is not a cost-effective option.*
Option 4 **(Improve disclosure requirements for issuers of structured finance products on an ongoing basis)**	*(+) more incentives for own due diligence, but the impact on reducing overreliance is likely to be limited.*	*(+/0) there would be additional compliance costs, but also indirect costs if there is unlimited access to critical price sensitive information data, but it is considered a cost-effective option as it regards making existing information available to all interested parties.*

To conclude, based on the analysis above, the highest scoring options in terms of effectiveness and efficiency are options 2 and 4 which are compatible with each other. If these options were pursued, financial firms would use more internal models for measuring credit

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98 Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

99 According to Annex VIII item 4.1. of the Prospectus Implementing Regulation post issuance reporting is voluntary unless it is considered to be a significant new factor, material mistake or inaccuracy according to Article 16 of Directive 2003/71/EC (Prospectus Directive).

risk and would re-assess capital requirements, which are currently based on external ratings. The increase of information disclosure for structured finance instruments would enable investors to perform an adequate risk assessment. Eventually, overreliance on external ratings would be reduced, thus leading to mitigation of "cliff effects" in the market.

Furthermore, with regard to overreliance issues it should be acknowledged that there will be a degree of voluntary reliance on ratings by small and individual investors which cannot be addressed by regulatory measures. Nevertheless, automatic and mechanical reliance on external credit ratings by regulated financial firms could be reduced.

The first of these policy measures (option 2) to limit overreliance are in line with the principles of the Financial Stability Board that were included in the new proposal for the modification of the Capital Requirements Directive (CRD IV[100]). The main provisions are (1) require that banks' investment decisions must never rely solely and mechanistically on ratings but always form their own internal credit opinion on every exposure; (2) require banks with a material number of exposures in a given portfolio (be it sovereigns, banks, or corporates) to develop internal ratings for that portfolio; (3) require (smaller) banks that do not use internal ratings to compare their internal credit opinion to the capital requirement resulting from an external rating. If the internal assessment shows that for a given loan, the external rating and the resulting capital requirement are too favourable compared to the internal credit opinion, the bank will be required to hold additional capital; (4) supervision of CRD IV will performed by the European Banking Authority EBA to ensure proper application of these measures (see Annex XV).

6.2. Policy options to mitigate the risks of contagion effects linked to sovereign debt ratings

Policy options
1. No policy change
2. Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff
3. Require CRAs to publish sovereign ratings after closing of EU trading venues
4. Require CRAs to conduct the sovereign debt ratings process more frequently
5. Extend powers of competent authorities (ESMA) to scrutinise rating methodologies
6. Require (EU) sovereigns to publish a standardised set of data on economic performance to enable credit risk assessment
7. Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in exceptional situations
8. Encourage an existing, independent EU structure or a brand new European Credit Rating Agency to issue sovereign credit ratings
9. Prohibit sovereign debt ratings

The full description of policy options is presented in Annex VII. Options 2, 3, 4, 5, 6, 7 and 8 can be combined and can complement each other. Option 9 is not compatible with the previous options which imply that the activity of issuing sovereign ratings is allowed.

Option 1 - No policy change

100 The legislative proposal on Capital Requirement Directive IV was adopted by the Commission on 20 July 2011.

Under this option, insufficient transparency would continue to exist in the area of sovereign debt ratings.

Even though some initiatives to enhance the quality of the sovereign rating process have been undertaken on a voluntary basis by major CRAs, as described in Annex V, their effectiveness in mitigating the problem is expected to be in perspective. rather limited Indeed, the initiatives adopted so far appear to be limited in scope, resulting basically in an update and improved disclosure of sovereign rating methodologies and do not provide any effective solution to all the remaining problem drivers presented in section 4.2 above. Moreover, measures which have been adopted individually by the agencies on a purely voluntary basis would raise serious issues concerning their harmonization and enforceability.

As a result, governments would continue to suffer from the limited time to assess accuracy and reliability of the rating process and to verify whether all relevant information has been properly factored in or not into the final outcomes. In addition, rating agencies would be allowed to continue issuing sovereign ratings even at particularly sensitive times, i.e. immediately ahead of auctions, during the syndication process or just before the close of business of European trading venues.

Investors would continue to have limited information on rating changes and might continue to (over)react to rating changes on the basis of an insufficient understanding of sovereign rating. As a result, considering also the interaction with the other problem drivers described above, the risks of relevant spill-over effects and financial markets disruptions linked to sovereign downgrades would continue to persist.

Furthermore, stability of EU Member States would remain subject to the risk of investors over-reactions to insufficiently transparent sovereign rating changes with the potential negative spill-over effects described in par. 4.2 above.

Option 2 - Introduce a requirement for CRAs to publish a full research report on sovereign debt ratings and allocation of staff

This option would enhance the capacity of investors to interpret the ratings since more detailed information on the underlying analysis and on the justification of ratings would be made available to them. In the consultation process, overall, a large amount of stakeholders, including some rating agencies considered that sovereign ratings should not be treated fundamentally different from other ratings. However, some Member States and industry stakeholders considered that more transparency of sovereign rations would be welcomed, particularly regarding methodologies and publication of the full research reports underlying ratings. This is expected to enable investors to better understand the rationale behind the sovereign debt ratings and to complement the judgement of the CRAs with their own assessment. Consequently, this option would also contribute to achieving the objective of reducing reliance on ratings as investors would be in a better position to determine their own opinion on a certain sovereign. As a result the risk of market disruption and negative spill-overs following a downgrade of a sovereign would be reduced.

In order to enhance the transparency of the process, additional figures on the allocation of staff could be made available as well. This would enable investors and market actors in general to better judge whether the CRAs devote adequate resources to the sovereign rating process and, consequently, reliability and quality of their sovereign ratings.

Since rating agencies would be asked to disclose information which is already available, this option is expected to imply limited additional costs and administrative burden.

Option 3 - Introduce a requirement for CRAs to publish sovereign ratings after closing of EU trading venues

Currently, ratings are sometimes published at sensitive period during trading, when not all investors can be always fully aware of changes of ratings and reasons for such changes. This could result in market disruption when ratings are published during or just before closing of trading when investors sell of based on unexpected rating changes.

This option would keep these risks to the minimum but ensure that publication of ratings cannot happen during particularly sensitive trading hours, i.e. immediately ahead of auctions, during the syndication process or just before the close of business of European trading venues. Instead, all relevant information on credit ratings would be disseminated among all market participants and investors outside trading hours.

All investors would thus have sufficient time to react properly to rating events on the basis of a well founded assessment of the underlying analysis and assumptions on which the credit event has been based.

As a result this provision would mitigate the risk of spreading of rumours during trading thereby reducing the probability of herding behaviour and market distortion. In this respect this measure is expected to limit risks of spill-over effects and contribute to enhance market stability.

However, since the measure would be applicable only to the EU markets, its effectiveness may be somewhat reduced since ratings might continue to be published outside Europe and trading of sovereign debt instruments can continue on trading venues outside the EU. However, ratings which published outside the EU and which would fall outside the endorsement or equivalence regime for third countries as provide for in the CRA regulation would not be allowed to be used for the purpose of regulatory capital.

Option 4 -Introduce a requirement for CRAs to conduct the sovereign debt ratings process more frequently

Under this option CRAs would be required to conduct a full review of sovereign processes ratings more frequently (every 6 months).[101] This would force CRAs to follow up more regularly on the main political and economic developments in Member States and mitigate the risk that rating agencies react too late to such developments with sudden upgrades on downgrades. This is turn would reduce the risk of over reactions from investors and of herd behaviour

This provision would make sure that any new relevant policy measure introduced by a sovereign which can entail positive effects on sovereign's fundamentals are timely reflected in the related debt rating.

This option would contribute to improving the communication of ratings to investors by CRAs as they would be required to undertake a full rating assessment on a more regular basis. It should be noted that this would not necessary entail an increased number of rating changes and CRAs would continue to be allowed to revise ratings when it is fully justified on the basis of their methodology and analysis.

For CRAs the provision would entail some additional costs as they would need to conduct more frequently the full rating process.

Option 5 - Extend powers of competent authorities (ESMA) to scrutinise rating methodologies

[101] Existing provisions only requires a credit rating agency to 'monitor credit ratings and review its credit ratings and methodologies on an ongoing basis and at least annually, in particular where material changes occur that could have an impact on a credit rating'. (See art 8.f of CRA regulation n. 1060/2009).

Under this option, supervision on rating methodologies would be reinforced since any new rating methodology developed by rating agencies would require prior notification to ESMA before its actual implementation. ESMA would be required to scrutinize the new rating methodology and check its compliance with existing requirements for rating methodologies as outlined in article 8.3 of the CRA Regulation. This option could apply for sovereign debt ratings but also for ratings of other asset classes.

Only after a positive assessment by ESMA, rating agencies would be allowed to apply the new methodology. As a result, this option is expected to contribute to substantially enhance transparency and quality of sovereign ratings since it would enforce the existing provision requiring CRAs to adopt rating methodologies which are 'rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing' (see article 8.3 of the CRA Regulation). It should be noted that in compliance with Article 23 of the CRA Regulation, this assessment by ESMA would be limited in scope and would not entail the interference with the content of rating methodologies.

In terms of efficiency this new task would entail some (limited) additional costs for the ESMA to validate the methodologies and for CRAs to provide the necessary documentation to the ESMA.

Option 6 - Introduce a requirement for (EU) sovereigns to publish a standardised set of data on economic performance to enable credit risk assessment by investors

The benefit attached to this option would be making all relevant information on economic and financial performance of EU sovereigns freely available in a standardised form to interested stakeholders, including investors, through a centralised database.

This would facilitate market participants to make their own assessment of creditworthiness of sovereigns, without excessively relying on external ratings.

Furthermore, credit rating agencies would be facilitated in issuing unsolicited ratings which could improve the number of credit opinions available to market participants.

However, it should be noted that relevant information to assess creditworthiness of EU sovereigns is already available to investors through distinct sources, including the European Statistical System (ESS) coordinated by EUROSTAT. The ESS is already committed in making EU economic statistics and the Principal European Economic Indicators (PEEI)[102] increasingly complete, comparable and timely. Consequently, a large amount of statistics and indicators on public finances are made available through EUROSTAT. There does not appear to exist any lack of data for the purpose of making credit assessment for sovereigns.

Therefore this measure would not considerably improve the quantity or timeliness of the information necessary for investors to make their own assessment. It would rather aim at improving its comparability and accessibility for investors and general public. Taking also into consideration the existing work-streams which should improve the reliability and quality

[102] PEEIs represent a comprehensive set of infra-annual macro economic statistics aiming to describe the economic and labour market situation as well as price developments in the euro area and the European Union, which are of particularly high importance for economic and monetary policy. The communication of the Commission to the European Parliament and the Council on Eurozone statistics “Towards improved methodologies for Eurozone statistics and indicators” of November 2002 has defined the list of PEEIs and their timeliness targets. Since 2002, achieved progress and remaining challenges have been constantly monitored. Each year Eurostat, in cooperation with the European Central Bank, drafts a Status Report on Information Requirements in the European monetary union (EMU) which is first submitted to the Economic and Financial Committee (EFC) and then to the Economic and Financial Affairs Council (ECOFIN). See the annual EFC Status Report on information requirement in EMU available from: http://epp.eurostat.ec.europa.eu/portal/page/portal/euroindicators/peeis/efc_status_report.

of available data on sovereigns, the added value of the measure is expected to be rather limited and therefore it would only have a limited impact in terms of reducing reliance on ratings and mitigating risks of spill-over effects.

Option 7 - Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in situations defined by the Regulation

In situations where the objectivity and quality of sovereign ratings can be impaired by upcoming market developments, like the case where all details of an international financial support programme (including those in the framework of the European Financial Stability Mechanism) to stabilize the economy of the sovereign are still unknown, ESMA would be given the power to temporarily restrict or ban the issuance of sovereign debt ratings while there is uncertainty with regard to timing, value, amount and conditions of the support. Other cases might encompass events which can substantially impact on market confidence and trigger excessive market volatility.

This would reduce the risk for concerned sovereigns to be subject to a premature and not fully justified downgrade with huge negative impact on their financial stability and further spill-overs to its economy and to that of neighbouring countries. Building on the previous example, the ban would be possible for ESMA until the complete information on timing, amount and conditions of the support is available.

However, it has to be observed that while, on one side, the measure might contribute to increasing the quality and accuracy of sovereign debt ratings thereby reducing the probability of unjustified downgrades, on the other side, as rating agencies operate at international level, a temporary ban could have limited effect. There exists a risk that regardless of a ban imposed on EU CRAs to issue certain sovereign debt ratings, ratings could still be issued by CRAs established outside the EU. However, in view of the third country regime, which provides for endorsement or equivalence of third country ratings, as outlined in Article 5 of the CRA Regulation this risk would be mitigated and limited as these ratings could not be used for regulatory purpose. Ratings which fall outside the third county regime already today cannot be used for regulatory purpose.

The measure in discussion could raise some concerns with respect to its compatibility with the freedom to conduct a business of Credit Rating Agencies and of investors (protected under Article 16 of the Charter of Fundamental Rights of the European Union). Subject to the principle of proportionality, the freedom to conduct a business may be limited, provided the limitations are necessary and genuinely meet objectives of general interest recognised by the Union or the need to protect the rights and freedoms recognised by the Charter (see Article 52 of the Charter).

Taking into account the relevance of the objective pursued through this measure, i.e. preserving financial stability in the EU, the proposed measures would comply with the principle of proportionality mentioned above if they are limited to clearly defined, exceptional circumstances, are limited in time, and constitute a measure of last resort. Conditions under which such restrictions and bans can be imposed would have be drafted with sufficient clarity and precision to prevent any potential arbitrariness or abuse. It has to be underlined that the expected impact of the measure on quality, reliability and timeliness of sovereign ratings would depend more on its deterring and inhibiting effects rather than on its actual use. Therefore, this measure can also be seen as the application of the precautionary principle.

Option 8 - Encourage an existing, independent EU structure or promote a brand new European Credit Rating Agency to issue sovereign debt ratings

Under this option an existing independent EU structure with adequate resources and capacity or a brand new European Credit Rating Agency would issue credit ratings for sovereign

issuers to provide market participants with a greater variety of opinions on credit worthiness of issuers. Sovereigns would get an additional rating from an independent and reputable source with a strong signalling effect to financial markets.

Two implementing modalities (sub-options) are possible under this option:

A - Encouraging the establishment of a brand new European Credit Rating Agency (this option is further analysed in section 6.3) which could offer the whole spectrum of rating services on all asset classes including sovereign bonds.

B - Encouraging an existing EU structure to take over the specific task of issuing sovereign ratings provided it has adequate skills and resources and is already active in the areas of macro prudential supervision, macroeconomic surveillance or in that of financial support to EU Member States. This sub-option is distinct to the European Credit Rating Agency described in section 6.3 as the scope would be limited to sovereign ratings and ratings would be conducted by an existing EU structure.

In order to limit the costs which the selected structure would incur to be fully equipped to perform the new task and to draw on the expertise already available within the EU institutional framework there are 3 possible institutions which could fulfil the task: the European Central Bank (together with the European System of Central Banks (ESCB)); the European Commission (Directorate General for Economic and Financial Affairs), and the newly established European Financial Stability Facility (EFSF), which will become the European Stability Mechanism as from 2013.

The ECB

In terms of effectiveness it would make sense to give central banks the task of issuing sovereign ratings. Historically, the two main objectives of central banks relate to the maintenance of monetary and financial stability. Both objectives are closely interlinked; monetary policy has significant implications for financial stability, while financial stability is an essential pillar for effective monetary policy. Identifying vulnerabilities in the financial and non-financial sectors, including in sovereign debt markets, and potential shocks in these markets is therefore a vital part of the work of central banks.

The ECB is at the heart of the newly established European Systemic Risk Board and has already a wide-ranging macro-prudential expertise together with adequate resources to pool all the necessary information, to carry out the right level of analytical work, including the development of methodology and management of a complex and wide set of indicators at EU and Member State level.

Moreover, the ECB has already a system to independently assess the creditworthiness of issues eligible for credit operations and for critically reviewing external assessments (Eurosystem credit assessment framework – ECAF)[103] which in particular allows the

[103] The Eurosystem credit assessment framework (ECAF) defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met. In the assessment of the credit standard of eligible assets, the Eurosystem takes into account credit assessment information from credit assessment systems belonging to one of four sources, namely:

- external credit assessment institutions (ECAIs),
- NCBs' in-house credit assessment systems (ICASs),
- counterparties' internal ratings-based (IRB) systems, or
- third-party providers' rating tools (RTs).

Additionally, in the assessment of the credit standard the Eurosystem takes into account institutional criteria and features guaranteeing similar protection for the instrument holder such as guarantees.
Available from: http://www.ecb.int/paym/coll/risk/ecaf/html/index.en.html.

recognition internally to the Eurosystem of the four in-house credit rating assessments from the respective EU National Central Banks[104].

Considering the high reputation and solid experience in carrying out monetary policy in the UEM independently, its sovereign ratings would carry a strong signalling effect for investors and would be able to substantially influence markets developments.

On the other hand, three major arguments can be presented against the attribution of the task to the ECB. First, there may be a conflict of interest between the activity of issuing sovereign debt ratings and the implementation of its monetary policy. In particular there might be concerns that the ECB for reasons of protecting the Eurosystem against financial losses in connection to its credit operations (i.e. depreciation of assets accepted as collateral) would issue more favourable sovereign rating policy than justified by underlying indicators and sovereign's fundamentals.

Second, there would be a reputational risk linked to the activity of issuing sovereign ratings. A perceived failure in assigning the 'right' rating to a sovereign might prove detrimental to the reputation of the ECB/ESCB, thereby jeopardising their credibility as a monetary authority as well.

Third, as the ECB is an independent institution with concrete tasks notably in terms of monetary policy set with the EU Treaty, in order to attribute a task of issuing sovereign ratings some institutional considerations would need to be addressed – which might possibly require a modification of the EU Treaty.

Having regard to the efficiency criterion, giving to the ECB the mandate of issuing sovereign debt rating would allow to fully benefit from the available qualified resources to carry out the underlying analytical and statistical work. Therefore the costs linked to implementation of this option would be limited.

European Commission (Directorate General Economic and Financial Affairs – DG ECFIN)

DG ECFIN plays a key role in macro-economic surveillance[105], including the design and implementation of large-scale macro-financial assistance programmes (often in cooperation with the IMF and the World Bank) to support Member States and partner countries facing severe financial or balance of payments difficulties.

In that respect it could be well placed to take over the duty of issuing sovereign ratings since it would be in a position to properly assess risks to the financial system and to economy of Member States.

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[104] Banque de France, Deutsche Bundesbank, Banco de Espana and Oesterreichische Nationalbanks.

[105] See Art. 99, §3 and 4 of the EC Treaty: "3. In order to ensure closer co-ordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Community as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment. For the purpose of this multilateral surveillance, Member States shall forward information to the Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary". 4. Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of economic and monetary union, the Council may, acting by a qualified majority on a recommendation from the Commission, make the necessary recommendations to the Member State concerned. The Council may, acting by a qualified majority on a proposal from the Commission, decide to make its recommendations public. The President of the Council and the Commission shall report to the European Parliament on the results of multilateral surveillance. The President of the Council may be invited to appear before the competent committee of the European Parliament if the Council has made its recommendations public"

However, in terms of effectiveness it could be argued that sovereign ratings issued by the Commission could lack sufficient credibility *vis-a-vis* markets. Indeed investors might have concerns on the objectivity of ratings in relation to potential political pressures from National Authorities and in relation to possible conflict of interests with the role of the Commission in support programmes to Member States (see above).

As regards the cost efficiency this option would lead to quite substantial costs in relation to the need to build the necessary expertise to perform credit rating activities, including development of methodologies and pooling of all relevant information.

The European Financial Stability Facility(EFSF) / European Stability Mechanism (ESM)[106]

Taking into account the mandate of the EFSF/ESM, i.e. to facilitate or provide financing to Euro Member States in financial difficulties[107], the ESFS/ESM could provide a possible alternative to the two previous options to identify a European entity to be entrusted with the task of issuing sovereign ratings.

However it can be argued that the EFSF/ESM would face in perspective a serious lack of credibility vis-à-vis markets and investors. On one side investors might have doubts on its independence and on objectivity and candidacy of its analysis because of its shareholders' structure (the Euro Area Member States). On the other side there might be concerns with respect to the conflict of interest with both its lending and its borrowing operations since a downgrade of a Member country or of a borrower country could potentially impact negatively on the rating of the ESFE/EMS itself.[108]

Finally, as the ESFE/EMS is an independent entity, some institutional considerations would need to be addressed (notably amendments to the legal instruments providing for the creation of this mechanism) before such a task could be attributed to this entity.

Moreover in terms of cost efficiency, taking into account the limited resources available to the EFSF[109], this solution would lead to substantial costs to provide for adequate expertise and technical infrastructure to perform the task.

Option 9 - Prohibit sovereign debt ratings

Under this option sovereign issuers would remain unrated. As a result, investors, including credit institutions, willing to acquire sovereign debt would be required to base their investment decision on their own exclusive risk assessment. This would contribute to the objective of reducing reliance on external credit ratings by investors. However, while large credit institutions could be expected to have the capacity and processes in place to perform such an assessment, as highlighted by the responses to the public consultation, smaller credit

[106] The European Financial Stability Facility (EFSF) was created by the euro area member states following the decisions taken May 9, 2010 within the framework of the Ecofin Council. As part of the overall rescue package of €750 billion, EFSF is able to issue bonds guaranteed by EAMS for up to € 440 billion for on-lending to EAMS (Euro Area Member States) in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the Eurogroup. EFSF is a Luxembourg-registered company owned by Euro Area Member States. On 28 - 29 October the European Council agreed on the need to set up a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole. Eurogroup Ministers agreed that this European Stability Mechanism (ESM) will be based on the European Financial Stability Facility capable of providing financial assistance packages to euro area Member States under strict conditionality functioning according to the rules of the current EFSF. The ESM will become operational as of mid-2013 following the expiry of the existing EFSF.

[107] See article 3 of EFSF Articles of Incorporation. Available from: http://www.efsf.europa.eu/attachments/efsf_articles_of_incorporation_en.pdf.

[108] It must be underlined that the EFSF Framework agreement provides for various credit enhancement mechanisms to exclude the situation referred in the text

[109] At the time of drafting the EFSF had a staff of around 12 officials.

institutions and smaller investors do not necessary have the skills and resources to carry out their own assessment for all sovereigns. This would put a disproportionate burden on them. Furthermore, the effective enforcement of such a measure could be effectively limited by unsolicited ratings carried out by CRAs licensed in jurisdictions outside the EU. Moreover CRAs would be confronted with the disappearing of an important source of revenues.

The permanent prohibition would heavily impact on the freedom to conduct a business (Article 16 of the Charter of Fundamental Rights of the European Union) of both credit rating agencies and investors. Indeed, considering the general nature of the prohibition, it raises serious concerns as to its compatibility with the principle of proportionality.

The summary of the analysis of different options to achieve specific objective 2 (mitigate risks of contagion effects linked to sovereign debt ratings) is presented in the table below. The analysis of the impact of these options on different stakeholder groups is given in Annex VIII.

	Effectiveness	**Efficiency**
Option 1 (baseline)	*n.a.*	*n.a.*
Option 2 **(Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff)**	*(++) transparency on sovereign ratings will be improves.* *(++) investors would get a better increasing understanding of ratings.*	*(++) detailed information on research report would be made available to investors free of charge.* *(-) CRAs would face lower profits since they would not be allowed to market the underlying (detailed) information on sovereigns.*
Option 3 **(Require CRAs to publish sovereign ratings after closing of EU trading venues)**	*(++) publication of ratings during sensitive times would be avoided and contagion effects of sovereign ratings reduced.* *(-) measure would be not effective in trading venues outside EU jurisdiction.*	*(0) since the measure would only affect the timing of the publication of the rating it would not entail additional costs for CRAs).*
Option 4 **(Require CRAs to conduct the sovereign debt ratings process more frequently)**	*(++) risks of contagion and spill over effects would be reduced.*	*(+) CRAs would be confronted with the limited additional costs linked to doing the full rating process more frequently.*
Option 5 **(Extend powers of competent authorities (ESMA) to scrutinise rating methodologies)**	*(++) transparency and quality of sovereign ratings enhanced.*	*(+) limited additional costs for competent authorities to scrutinise ratings.* *(+) limited additional costs for this additional validation process for CRAs.*
Option 6 **(Introduce a requirement for (EU) sovereigns to publish a standardised set of data on economic performance to enable credit risk assessment)**	*(+) access to data on sovereigns and investors' own assessment would be facilitated.*	*(-) duplication of costs with on going initiatives of the ESS to enhance reliability and quality of information on sovereigns.*
Option 7 **(Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in exceptional situations)**	*(++) risks of contagion effects of sovereign ratings would be reduced.* *(+) accuracy and quality of sovereign ratings would be improved.* *(-) risks of adverse market reactions enhanced.*	*(0) no direct costs involved by the adoption of the measure.*
Option 8 **(Encourage an existing independent EU structure or promote a brand-new European Credit Rating Agency to issue sovereign debt ratings)**	*(++) financial stability enhanced through the availability of a credible alternative to existing commercial ratings for sovereigns.*	*(+/0) additional costs for the establishment of a new EU Agency (case of public funding)* *or* *(+)limited additional costs for the existing EU structure to build the expertise/technical infrastructure necessary to perform rating activities*
Option 9 **(Prohibit sovereign debt ratings)**	*(+) reliance on sovereign ratings would be reduced.* *(-) effectiveness would be limited by the continuous issue of sovereign ratings outside the EU jurisdiction.*	*(--) investors, particularly small investment firms and small credit institutions would be confronted with the costs of setting up their own risk assessment capacity.* *(-) CRAs would loose an important source of revenues.*

Based on the analysis above on the effectiveness and efficiency of the various options presented, options 2, 3, 4, 5, and 7 as the preferred ones. Indeed their joint implementation would provide an adequate response to the various issues (problem drivers) described in section 4.2 above. Indeed measures included in options 2, 3, 4 and 5 are expected to improve transparency of sovereign rating process and therefore enhance the quality, objectivity, and reliability of sovereign ratings. In terms of effectiveness they all are expected to reduce the negative spill-overs and 'cliff' effect of sovereign ratings (downgrades). With respect to cost efficiency, the implementation of such options would entail limited additional costs, particularly for CRAs which would have to face a reduction in their sources of revenues and bear the costs of doing the full sovereign rating process more frequently and comply with the obligation of prior validation of their methodology by the ESMA. Furthermore, publication after closure of European trading venues (option 3) would ensure that market overreactions and heard behaviour is reduced. In exceptional circumstances which could trigger market volatility or affect the reliability and completeness of the rating process, for instance pending the disclosure of the terms and conditions of a financial support package granted to a Member State, ESMA would be empowered to temporarily ban sovereign ratings as a measure of last resort, ensuring that risks of contagion effects of sovereign downgrades are mitigated.

6.3. Policy options to improve credit rating market conditions

Policy options
1. No policy change
2. Encourage the emergence of a network of small and medium size rating agencies
3. Encourage the emergence of a new European rating agency
4. Harmonise ratings scales to improve comparability of ratings between CRAs
5. Establish a European Rating Index (EURIX)
6. Require CRAs to issue joint ratings at the level of the rating committee
7. Ban large CRAs from acquiring small and medium-sized CRAs
8. Introduce temporary market share ceilings for CRAs
9. Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs

The full description of policy options is presented in Annex VII. Options 2, 3, 4, 5, 6, 7, 8 and 9 are not mutually exclusive and can be combined.

Option 1 - No policy change

Under this option, existing oligopolistic market structure, with three main rating agencies dominating the market is expected to persist.

The landscape of the rating industry would not be substantially modified by the outcomes of the ongoing registration process under the CRA Regulation. At this early stage, six small and medium rating agencies have been registered and it is too early to determine weather one of these agencies has the potential and the ambition to turn itself into a full-blown rating agency covering a wide reach in terms of asset classes (including sovereign debt, corporate and structured finance products) and territory (see Annex IV). A preliminary assessment does not suggest that in the short term a true competitor, comparable in size, reputation and territorial reach to the three rating agencies with a dominant market share could emerge.

Recently, there have been signals on possible market-driven initiatives for the future establishment of a European Rating Agency in the form of private Foundation[110] which could be able to inflate more competition in the market of credit rating services.

However, it is still too early to make any form of evaluation of these initiatives since they are merely at the stage of announcements and it is impossible to assess their concrete chances of success.

Therefore for the time being it is likely that issuers and investors would continue to be confronted with the current structure of the market which implies a limited availability of ratings and limited opportunities to compare different credit opinions for investors. Issuers would continue to have a limited choice as regards the service provider for the rating of their debt instruments: consequently issuers could be confronted with potential abuses on prices. This could affect small and medium enterprises for which the access to financial markets could become costly. Nevertheless, if any private initiative materialises and results in one or more new competitors who would gain ground in terms of client basis and credibility, this would be undoubtedly a positive development enhancing competition and choice for the market.

Option 2 - Encourage the emergence of a network of small and medium sized credit rating agencies

Promoting through a EU-funded programme a network of small and medium rating agencies could facilitate this type of CRAs to enter the market. This network could facilitate the sharing of best practices and resources and eventually lead to the emergence of more sizeable market players which could compete in terms of size, instruments rated, geographic reach and reputation of the large CRAs. Entry into the market and survival of new competitors would be also encouraged. The consultation process showed that the majority of stakeholders would welcome more choice and market players in the rating industry.

Due to their size and limited scope of activities, small and medium sized credit rating agencies lack resources to create such a network by market forces. However, the public consultation on this initiative outlined great interest of small and medium-sized CRAs in having an opportunity to share knowledge, enhance capacities for growth and eventually, extend the scope of their activities, particularly with a view of operating in a cross-border context. There was therefore support from a group of small and medium-sized CRAS for the idea of a European Network of Small and Medium-sized Rating Agencies. Furthermore, a network could contribute for small and medium-sized rating agencies to obtain economies of scale through sharing of data and best practices, which is an important factor currently limiting market entry. The European Parliament, in its own initiative report on rating agencies, supported the creation of such a network. However, some regulators and governments questioned the effectiveness of such a network.

For investors, such a measure would lead to more choice with respect to the ratings available for the same debt instrument or the same issuer. For issuers this option could over time result in an increased offer of rating services and easier (and less costly) access to capital markets.

Moreover it can be argued that higher competition and market contestability would push incumbent CRAs and new entrants to compete both on the side of prices and on that of the quality of the services provided. This would induce CRAs to increase their investments on the collection and processing of the information and on the methodological tools. This in turn

[110] Recently the Consultancy Company Roland Berger has announced its intention to develop a European rating agency. Available from: http://www.rolandberger.com/media/press/releases/Initiative_to_establish_European_Rating_Agency.html.

would reinforce the discipline exerted by the 'reputation mechanism' since CRAs would incur in higher reputational risks if they underinvested and did not keep pace with their competitors in carrying out their business properly[111].

It should be noted that any network of small and medium-sized rating agencies would have to adhere to existing competition rules[112] which apply to all companies in the EU. More details on the implementing modalities are provided in Annex IX.

Option 3 - Encourage the emergence of a brand-new European credit rating agency

Under this option, the setting-up of a new European rating agency would be promoted either via the establishment of a public institution entirely financed through the Union budget or by providing direct funding to a European agency in the form of a private foundation.

Some Member States as well as the European Parliament suggested that the idea of public/private structures should be further considered and analysed. At the same time, some Member States noted the problems of credibility and conflicts of interest that could be caused by direct funding arrangements and which would need to be addressed. Some national regulators and several private enterprises opposed the creation of a new European CRA.

Such a new entity would provide the whole range of rating services and cover all the asset classes. In this respect the EU structure issuing sovereign ratings envisaged under option 8 of the previous section 6.2 and the European rating agency could co-exist and increase further the offer of services to issuers and investors. Eventually, this could lead to lower prices for investors in the rating market and could increase the information available to investors through a wider range of credit ratings.

However, it would likely take at least 5 – 10 years for such new entity to become capable to compete with the established CRAs by offering investors and issuers a real alternative for rating services, thereby enhancing competition within the market for such services.

Details on the estimation of costs of the new entity are provided in Annex XI.

Public European credit rating agency

In terms of effectiveness a European rating agency entirely public would raise concerns of distortion of competition as it would be less under market pressure to develop competitive products and to price them adequately as its entire costs could be covered and thus the bankruptcy avoided. Furthermore, the establishment of such an agency could hamper new private market entrants that want to establish themselves on the market and progress gradually towards a sizeable competitor and thus further promote market concentration. In addition, the public could fear a preferential treatment or a more accommodating behaviour from supervisors. Moreover investors could be concerned, despite existing rules provided for in the CRA Regulation[113], about the conflict of interest that this model would entail particularly in the area of sovereign ratings (see analysis under option 8 in section 6.2 above). This could be partially addressed by an appropriate design of the governance to ensure the Agency's independence. On the other side the public nature of the entity could positively impact on its credibility provided it is backed by a positive track record of rating activities. However, for

[111] It is worth mentioning that according to some Authors increased competition might result in lower overall quality of ratings, i.e. more issuer-friendly and less informative ratings. See B. Becker and T. Milbourn, 'Reputation and competition: evidence from the credit rating industry, 2009.

[112] Also this option would raise the same concerns of competition as option 3 as the EU-funded network would be competing on the market with private companies. Further information exchange between competitors can - depending on the market characteristics and the characteristic of the information exchange - be in contradiction with European Competition rules.

[113] As described in section 4.5.

the reasons mentioned above, it remains uncertain if a purely public agency would obtain sufficient market confidence among investors.

As regards the profile of cost efficiency this solution would be undoubtedly the least efficient and, taking into account the current EU budget constraints, it would raise serious concerns as regards its feasibility and sustainability in the long term.

Private credit rating Foundation

Alternatively, a European rating agency in the form of private foundation would have a lower capacity to distort competition within the market of rating services than an entity of public nature and being potentially more independent from governments (for instance in issuing sovereign ratings) if it received only initial funding and then had to compete on the market and generate revenues from the sale of its own products. On the other side, this model might raise concerns as regards potential conflicts of interest since the new agency would have a financial interest in developing business with issuers[114] which could lead to 'inflated ratings'.

In order to facilitate its establishment, the European Rating Agency could be granted EU financing to cover part of the start-up costs in the form of a Union loan, via a grant agreement of following a competitive procedure (open call for tenders), or coming from the European Investment Bank. In this context it is important that any financial support provided by Member States is in compliance with the provisions of Articles 107-109 TFEU on state aid.

As regards the efficiency profile, this solution would imply a lower recourse to public resources even though, taking into account the budget constraints mentioned above, its feasibility should be carefully assessed trough an in-depth preparatory analysis.

Option 4 - Harmonise ratings scales to improve comparability of ratings between CRAs

This measure would facilitate investors in comparing ratings from distinct agencies through a harmonised standard reference scale to be used by registered and authorised rating agencies. This would enable investors to compare ratings from smaller market players with the dominant market players more easily. Furthermore, it would also contribute to the understanding of ratings by investors.

As a result, market access for small rating agencies would be facilitated to some extent which could increase competition. Furthermore, this option could improve transparency on ratings and their interpretation for stakeholders including rating agencies and issuers.

The technical standard setting out harmonised rating scale would be developed by the ESMA. All CRAs would need to produce and publish tables showing the correspondence between their existing rating scales and the newly established rating scale.

Option 5 - Establish a European Rating Index (EURIX)

Under this option, rating agencies would have to communicate each newly issued rating to a central entity such as the ESMA, which could take care of the centralised publication of the rating and related information. This would be made freely available to investors, possibly though the ESMA website.

This measure would improve visibility for investors of the available ratings for debt instruments particularly for newly established rating agencies. Therefore it would help new market entrants to gain visibility among investors and increase their reputation over time. Investors would be helped in comparing credit opinions and make their own assessment. This would indirectly contribute to the objective of reducing reliance on ratings. It should be noted

114 In the case of the "issuer-pays" model.

that the creation of harmonised standards on rating scales would be instrumental to the development of the EURIX.

Option 6 - Require CRAs to issue joint ratings at the level of a rating committee

Under this option, large CRAs would be required to issue ratings jointly with a smaller CRA. Both credit rating agencies would have joint responsibility for the credit ratings issued. As small and medium-sized CRAs would be required to participate in the rating process together with large CRAs, this option would improve reputation of small CRAs and promote the development of new market entrants in the credit rating industry.

Furthermore, the joint credit ratings could improve quality of ratings through complementary and combined expertise in the preparation of the joint ratings as well as in the analysis of the findings and conclusions.

However, as rating agencies would issue jointly ratings, the number of views and opinions on credit risk would be limited. Therefore, this option would risk limiting competition in the rating industry. Furthermore this option could generate additional conflicts of interests and competition policy issues as small and large rating agencies would have to cooperate and exchange information.

As this option would imply involvement of only smaller CRAs at the level of rating committee this option could add up roughly 10% to the costs of a credit rating. These additional costs would most likely make ratings more expensive and be transferred to issuers.[115]

Option 7 - Ban large CRAs from acquiring small and medium-sized CRAs

The growth of the three biggest CRAs over the last decade can be partially explained by their acquisition of other firms (see Annex IV. Section 2). Under this option, a CRA with a relevant market position would therefore not be allowed to acquire smaller rivals. The EU Merger Regulation[116] which is only applicable to transactions with Union dimension and which reach the merger control thresholds appears insufficient to tackle this issue. A temporary ban on acquisition and mergers could limit the growth of large CRAs and let new market entrants enter the market and gradually develop their market share. The ban should be temporary, but long enough – at least ten years - to enable smaller CRAs to build up their necessary reputation.

Taking into account the current market structure, this measure, on its own, is likely to have a limited effect. However, this option could become important if other measures were taken to promote the growth of small CRAs or entrance of new rating market players. Finally, mergers and acquisitions can be justified, in some cases, by the quest for increased efficiency as a result of the combination of resources of the companies involved.

Option 8 - Introduce temporary market share ceilings for CRAs

Under this option large CRAs would need to accommodate a maximum ceiling of market share, transferring business to smaller competitors. As a result, smaller CRAs would be facilitated to acquire business and build reputation, enhancing the level of competition in the market. Therefore, this option could substantially increase the number of sizable market players in the rating industry.

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[115] The approximate costs are calculated on the information on joint audits in France.

[116] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings, OJ L 24/1, 29.01.2004. Pursuant to Article 2(3) of the merger regulation only a concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market.

However, it is worth underlining that in the short-run this measure could result in a reduced offer of services for issuers and potential increase of prices together with lower availability (and quality) of ratings for investors that might cause further instability in the financial markets. Indeed, all along this initial phase, while small and medium-sized CRAs would need enough time and resources to build up adequate capacity and reputation, large CRAs would be required to start reducing market share. This might force small CRAs to replace incumbents in providing certain typologies of services when they are not as efficient as their competitors (lower economies of scale, lower economies of scope) or even are not able to provide such services.

These negative effects could be mitigated by the introduction of a phase-in period (e.g. transition period 5 years) ensuring that both the supply and the demand side would have enough time to adjust to new requirements.

However such a measure would go beyond Article 102 of the TFEU which only prohibits the abuse of a dominant position and not a dominant position as such. It would also amount to an artificial engineering of market structures which might have evolved naturally based on competition on the merits.

Option 9 - Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs

Require CRAs to disclose policy on pricing of ratings

This option would require CRAs to provide investors, issuers and competing CRAs with the information on the policy of ratings pricing, including objective pricing criteria. CRAs would be required to extend existing disclosures of the current transparency report[117] with the aggregate information on the actual fees charged for different asset classes. This limited disclosure of pricing information would further facilitate potential customers to compare the prices they would have to pay for the services rendered by different CRAs and in this way promote competition.

Require CRAs to ensure that the fees they charge for their services are not discriminatory

This option would also imply price regulation thereby a CRA would be required to ensure that the prices and fees they charge for their services are not discriminatory and based on costs, i.e. different consumers are not charged a different price for an identical service taking into account the actual costs. In this regard CRAs would have to provide ESMA with detailed information on fees. This option would also contribute to addressing conflicts of interests due to the issuer's pays model as pricing for rating services would be more transparent for issuers and the fees would not based on any form of contingency. This measure would be indispensable to effectively tackle inherent conflicts of interest in the "issuer pays" model. Information on fees would also enable all market participants as well as ESMA to better assess the risks of possible hidden pricing practices which could be conducted against the interests of some issuers, investors or products.

However such rules need to be carefully drafted to make sure that they do not facilitate collusive behaviour among CRAs.

The summary of the analysis of different options to achieve specific objective 3 (improve credit rating market conditions) is presented in the table below. The analysis of the impact of these options on different stakeholder groups is given in Annex VIII.

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[117] Art 12 of Regulation 1060/2009 requires rating agencies to publish an annual transparency report. Annex I section E (III) outlines that the transparency report should include financial information on the revenue of the credit rating agency divided into fees from credit rating and non-credit- rating activities with a comprehensive description of each.

	Effectiveness	Efficiency
Option 1 (baseline)	*n.a.*	*n.a.*
Option 2 (Encourage the emergence of a network of small and medium size rating agencies)	*(++) facilitate market entry of small and medium rating agencies. (++) create more choice for investors and issuers reducing reliance on ratings.*	*(+) costs to set up a network are estimated moderate and proportionate.*
Option 3 (Encourage the emergence of a new European rating agency)	*(+) creation of more choice to investors and issuers reducing reliance of ratings.*	*(--) substantial costs for EU budget (funding of start-up costs) and possible distortion of competition (Public agency.)*
Option 4 (Harmonise ratings scales to improve comparability of ratings between CRAs)	*(+) increased transparency which would enable investors to make own assessment and compare distinct ratings. (+) small market entrants would be facilitate in entering the market.*	*(+) limited costs for all CRAs to enable the mapping of new rating scales.*
Option 5 (Establish a European Rating Index (EURIX))	*(+) increased possibilities to compare distinct ratings available in the market. (+) small market entrants would gain better market access due increased visibility.*	*(+) limited costs for ESMA to establish and manage and update index on an ongoing basis. (+) limited costs CRAs to communicate information to centralised entity.*
Option 6. (Require CRAs to issue joint ratings at the level of the rating committee)	*(+) it would increase the visibility and build trust on quality of ratings by smaller CRAs. (-) it is quite likely that there would be no change regarding concentration and choice in the market.*	*(-)additional costs for CRAs to comply with the provision.*
Option 7 (Ban large CRAs from acquiring small and medium-sized CRAs)	*(0/+) the credit rating market would remain highly concentrated. Though development and growth of small CRAS would be facilitated. Furthermore, risks that successful new market entrants would be taken over by larger market players would be mitigated, which would contribute to more choice in the rating industry..*	*(0) costs are likely to appear in terms reduced economies of scale due to banned acquisitions.*
Option 8 (Introduce temporary market share ceilings for CRAs)	*(+) effective in reducing market concentration.*	*(0)significant costs are likely to appear in terms reduced economies of scale due to giving up their businesses to smaller CRAs; disruptions in the market cannot be excluded either.*
Option 9 (Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs)	*(+) Price transparency and regulation of prices would contribute to more intense competition.*	*(+) Limited costs for CRAs to comply with the provision.*

Based on the analysis above, option 2, 4, 5 and 9 are the preferred options in order to improve choice and enhance competition within the market of rating services. Under this package, small and medium size rating agencies would be stimulated to exchange information which could facilitate new market entrants in the market. Furthermore, common standards for rating scales would facilitate comparison of ratings among investors. Additionally, visibility of ratings by new market entrants would be improved through the establishment of a European Rating Index. In addition, improved transparency on pricing policies and fees would enable to avoid potential conflicts of interest in the provision of rating services and would facilitate competition in the rating market. Option 7, The ban for large CRAs from acquiring small and medium-sized CRAs would be necessary to ensure effectiveness of other preferred options, including those addressing issues on CRAs' independence. However, this ban on its own would not be effective to change the market structure and could be circumvented by CRAs.

6.4. Policy options to ensure right of redress for investors

Policy options
1. No policy change
2. Introduce civil liability of CRAs into EU legislation

3. Ensure civil liability of CRAs towards users of credit ratings before national courts

Option 1 – no policy change

Without a policy change the current situation would persist, i.e. investors in many Member States would face legal difficulties in claiming damages from CRAs, even if the latter infringed its obligations with gross negligence that resulted in faulty ratings.[118] Investors' right of redress and, accordingly, the level of exposure of CRAs to civil liability claims would vary considerably from one Member State to another. This could incentivise CRAs to favour the application of laws of such Member States where their exposure to potential civil liability claims is more limited.

It could be argued that the fact that the CRA Regulation has empowered ESMA to impose sanctions on CRAs for having infringed the CRA Regulation already provides sufficient incentives to CRAs to comply with the CRA Regulation. However, the possibility of sanctioning CRAs is not a substitute for an efficient right of redress for investors and does not compensate investors for their losses.

Accordingly, several respondents from various stakeholder groups encompassing some governments, regulators and banking industry bodies supported the possibility of civil liability claims against CRAs, but only for gross negligence or intent. Overall, there seemed to be general support (with the notable exception of the CRAs themselves, arguing that this would, for instance, increase reliance) for the notion that it should be possible to pursue civil action, in the case of both solicited and unsolicited ratings, but that such action should be reserved for severe infringements.

Option 2 – Introduce civil liability of CRAs into EU legislation

Under this option a new specific provision on which investors could directly base claims for damages against CRAs resulting from gross negligence or misconduct would be introduced in the CRA Regulation. This provision would directly define the conditions under which CRAs can be held liable. The specificities of the rating activity would need to be taken into account. Ratings contain to a certain extent a prognosis for the future, and in some situations there could be a virtually unlimited number of investors who could claim damages from a CRA that infringed the CRA Regulation. This might suggest that only cases of gross negligence should trigger civil liability. The advantages of this option over option 1 include that civil liability of CRAs to investors would be possible throughout the EU and under the same conditions. This would ensure an equal right of redress for investors against CRAs. By granting access to justice in these cases, this option would positively impact on the right to an effective remedy and to a fair trial as guaranteed by Article 47 of the Charter of Fundamental Rights.

As CRAs would be equally exposed to civil liability, there would be no incentive for forum shopping. The fact that civil liability of CRAs would be possible (under the conditions defined in the CRA Regulation) would provide additional strong incentives for CRAs to avoid misconduct and comply with the CRA Regulation.

The disadvantage of this option is that, depending on the level of detail of EU rules, it could increase the complexity of civil law systems of the Member States. Civil law systems in general cover all types of activities, and are often based on principles which horizontally apply to all claims (e.g. the appropriate standard of fault, causality link). Regulating civil liability of CRAs on the EU level while most other areas stayed at the national level would increase the complexity of the civil law systems and could make it more difficult to apply in

[118] See table in Annex VI, section 2.4 describing on what legal basis and to what extent investors can claim damages against CRAs having infringed the CRA Regulation.

practice. In any case, liability claims would need to be brought before national courts, under national procedural rules. In addition this option may go beyond what is necessary to ensure that users of ratings have a sufficient right of redress.

Option 3 – Ensure civil liability of CRAs towards users of credit ratings before national courts

Under this option, a provision in the CRA Regulation would ensure civil liability of CRAs towards investors before national courts. This provision would set the principle and some conditions under which civil liability of CRAs should be possible. For instance, it could stipulate that CRAs infringing requirements of the CRA Regulation by gross negligence should be held liable and that it should not be permitted to exclude civil liability. As in the case of option 2, this option has the advantage that it would ensure that investors in all Member States have a sufficient right of redress against CRAs before national courts.[119] By granting access to justice in these cases, this option would positively impact on the right to an effective remedy and to a fair trial as guaranteed by Article 47 of the Charter of Fundamental Rights.

Furthermore, the possibility of civil liability of CRAs would create additional strong incentives for CRAs to comply with the requirements of the CRA Regulation.

In comparison with option 2 this has the advantage of taking into account the specificities of national civil law orders. In fact, option 3 requires the supplementary application of national rules. This option would thus be in accordance with the principle of subsidiarity. On the other hand option 2 may be more effective in ensuring a uniform right of redress for all European investors as there would be only one legal basis for claims throughout the EU.

A summary of the analysis of the different options to ensure a right of redress for investors is presented in the table below.

	Effectiveness	**Efficiency**
Option 1 (baseline)	*n.a.*	*n.a.*
Option 2 **(Introduce civil liability of CRAs into EU legislation)**	*(++) objective to ensure right of redress fully met.* *(++) uniform provision in EC legislation excludes forum shopping.*	*(+) uniform provision in CRA Regulation ensures harmonised approach.* *(-) may go beyond what is necessary and increase complexity within the national civil law systems.*
Option 3 **(Ensure civil liability of CRAs towards users of credit ratings before national courts)**	*(++) objective to ensure right of redress fully met.* *(+) risk of forum shopping reduced.*	*(+) respect specificity of national civil law orders.*

Based on the analysis above option 3 would be the preferred option. Both option 2 and option 3 provide clear advantages compared to the status quo in achieving the operational and specific objective. In particular, both would ensure that investors profit from an appropriate

[119] An efficient right of redress under this option (and also option 2) presupposes that the applicable law under private international law rules (Rome II Regulation) would be the law of a Member State. Under Art. 4 of Rome II the applicable law is the law of the country where the damage occurs, which could be in case of financial instrument purchases either the place of purchase, the place where the securities are deposited or where the account is located. Following these criteria purchases by EU investors on EU markets will in most cases lead to the application of the law of a Member State which will ensure an efficient right of redress under this option. It should also be considered in this context that other important jurisdictions have recently strengthened the civil liability of credit rating agencies. For instance in the US , the Dodd-Frank Wall Street Reform and Consumer Protection Act, Subtitle C, Sec 931 ff, stipulates that CRAs should be accountable in the same way as accounting firms or securities analysts.

right of redress against CRAs, reduce the risk of forum shopping and provide strong incentives for CRAs to comply with their legal obligations and to issue good quality ratings. While option 2 would have the benefit of creating a completely harmonised basis for investors' claims against CRAs, option 3 may achieve the objectives in a more efficient way by relying more on national rules which is preferable in view of the principle of subsidiarity. Both, option 2 and 3 would impact positively on the right to an effective remedy and to a fair trial as guaranteed in Article 47 of the Charter of Fundamental Rights.

6.5. Policy options to reinforce independence of credit rating agencies and improve credit rating methodologies and processes

Policy options
1. No policy change
2. Require investors to pay for ratings ("investor-pays model")
3. Require trading venues to set up and ensure the administration of the "Trading venues pay" model
4. Require CRA selection to be undertaken by an independent board
5. Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself
6. Introduce specific requirements on CRAs' independence and objectivity in relation to their shareholders
7. Strengthen rules on disclosure of rating methodologies
8. Require CRAs to inform issuers sufficiently in advance of the publication of a rating

The policy options presented above are not necessarily mutually exclusive, hence combinations of two or more options are also analysed where appropriate.

As explained in the problem definition, the issuer pays model's conflicts of interest are highly sensitive to all market participants and should therefore be carefully assessed. In this context it is important to consider the steps taken in the US under the Section 939 F(b) of the Dodd-Frank Act of July 2010, requiring the SEC to carry out a study of CRA compensation and remuneration models within two years of that date.[120]

Option 1 – No policy change

Even if the CRA Regulation neither imposes nor favours a specific remuneration model, the issuer pays model would without a policy change, possibly, continue being the most dominant in the market and conflicts of interest related to this model would persist. Since CRAs have a financial interest in generating business from rated firms, they may tend to give issuers that

[120] Specifically, the Dodd-Frank Act requires that: "The Commission (SEC) shall carry out a study of 1) the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models; 2) the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products, including (a) an assessment of potential mechanisms for deter-mining fees for the nationally recognized statistical rating organizations; (b) appropriate methods for paying fees to the nationally recognized statistical rating organizations; (c) the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and (d) any constitutional or other issues concerning the establishment of such a system; 3) the range of metrics that could be used to determine the accuracy of credit ratings; and 4) alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings".

account for a large proportion of their income higher ratings than justified[121], even if the CRA Regulation partially addresses this issue by disclosure rules and procedural requirements.[122]

Moreover, without a policy change, conflicts of interest related to a CRA's shareholders structure may potentially occur as the current CRA Regulation does not explicitly include controlling shareholders in the provisions that prohibit specific rating actions.[123]

Without a policy change investors would not always be well informed and be able to understand the underlying assumptions and limits of rating methodologies.

Finally, without a policy change, it would still be possible for CRAs to notify issuers outside working hours of an imminent rating action, which does not allow the issuers to check the accuracy of the underlying assumptions.

Option 2 – Require investors to pay for ratings ("investor pays model")

The advantage of this option would be that conflicts of interest related to the issuer-pays model would be avoided. Since in general investors should have an interest in accurate ratings, an investor-pays model would potentially enhance the quality of ratings.

On the other side, there are also potential disadvantages related to the investor-pays model. First, investors may have their own interests[124], so ratings paid by investors would not be free of potential conflicts of interest.

Furthermore, investors are likely to ask for "compensation" for increased rating costs by requiring higher returns on investments, so the likely outcome of this model is an increased cost of funding for issuers. Moreover, in contradiction to FSB principles, investors' reliance on ratings could further increase.

Finally, an obligatory investor-pays model could make it difficult for smaller issuers of less liquid issuances to find a CRA willing to rate them and, consequently, to raise funds at the capital markets. CRAs may refuse to rate such issuances due to the uncertainty whether there will be enough investors willing to pay for them. Also many respondents to the consultation opposed an obligatory investor-pays model, pointing to conflicts of interest that are related also to this model.

Option 3 – Require trading venues to set up and ensure the administration of the "Trading venues pay" model

The advantage of this option would be that conflicts of interest related to the issuer-pays model and the investor pays model would be avoided as it would be the trading venue (and not the issuer or investor) which would select and pay the rating agency. Trading venues do not have an own interest in the rating and are impartial. This model would therefore remove the incentives for a CRA to issue favourable ratings in hope of repeated rating services for the same issuer.

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121 See above Section 4.5.1. and Annex VI, 2.5.

122 For instance, credit rating agencies have to undertake all necessary steps to ensure that their ratings are not affected by any existing or potential conflict of interest (Art. 6 (1) of the CRA Regulation in conjunction with Annex I, Section B 1). They have to disclose to the public the names of the rated entities from which they receive more than 5 % of their annual income (Art 6 (2) in conjunction with Annex I Section B 2). Rating analysts may not be involved in any negotiation regarding fees with a rated entity and their remuneration shall not depend on the remuneration received from the rated entity (Art. 7 (2), (5) of the CRA Regulation).

123 Art. 6 in connection with Section B 1.-3 of the CRA Regulation. It would for instance not be explicitly prohibited that a CRA issues a credit rating on an instrument in which the CRA's controlling shareholder has a direct ownership interest.

124 See Section 4.5 and Annex VI, 2.5.

However, the trading venues-pay model has several disadvantages. First, the effectiveness of this model can be questioned as it would only cover securities that are traded on trading venues, but not those which are traded over-the-counter. Currently, a large proportion of securities are not traded on trading venues.[125] In order to avoid the trading venues-pay model to apply, issuers may even decide to delist from trading venues.

Secondly, it would be difficult to find criteria that trading venues could use in order to attribute rating mandates to credit rating agencies. Where CRAs are allocated to issuers on a pure random basis, CRAs would win business, even if they were not responding to the needs of investors. If a trading venue would have discretion in selecting a CRA they could potentially face civil liability claims for having selected an inappropriate CRA. Finally, this model would require trading venues to substantially restructure their business, and hire experts which would be able to select appropriate CRAs. It is not sure whether trading venues currently have sufficient capacity and experience to administer such a model. Trading venues would probably pass those costs onto their clients which could make public listing more expensive. Making public listing more expensive would go against the strategic objective to facilitate access to capital markets, particularly for smaller and medium enterprises (SMEs). Last but not least, trading venues would be subject to civil liability claims for the choice of a given CRA.

Option 4 – Require CRA selection to be undertaken by an independent board

Under this option an independent "Credit Rating Agencies Board" comprising supervisors, issuer representatives, subscribers/investors and CRAs would be empowered to select a CRA for an issuer.[126] The issuer would remain free not to be rated at all, or to mandate an additional CRA apart from the one selected by the board.

The advantage of this option would be that conflicts of interest related to the issuer-pays and investor-pays models would be avoided as it would be an independent board (and not the issuer or investor) which would select the rating agency. Due to its balanced composition the board could be expected to be impartial when selecting a CRA.

However, the effective functioning of the rating market requires that securities issuers are free to choose their rating provider. If ratings are centrally allocated, incentives for CRAs to maximize their operational performance and to compete on the basis of price and service quality could significantly be reduced. Similar concerns were raised by some respondents to the public consultation.

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[125] In Europe, the ratio of listed to unlisted companies is 1:3. Data from Property Funds Research, Bloomberg and Macquarie Research, cited in Compatible not competing, 19 November 2010. Available from: http://www.ipe.com/realestate/compatible-not-competing_37991.php?categoryid=1056.

[126] In the US, there is currently a debate whether conflicts of interest due to the issuer pays model should be addressed by creating a ratings oversight board to select CRAs for rating structured finance instruments: The "Franken Amendment" calls on the Securities and Exchange Commission to create a ratings oversight board, with investor representatives in the majority. The board could choose a rating agency to conduct the initial evaluation of each new set of asset-backed bonds or other structured-finance products. Assignments would be based on objective measures of rating accuracy over time. Securities issuers would not be allowed to play a role in the assignment process. There would be two objective measures to evaluate the accuracy of rating agencies: (1) one standard of comparison is long-term yield: if two securities have the same risk profile, they ought to produce similar rates of return over time; (2) another simple gauge is the frequency with which investment-grade bonds default or lose significant value. Under the Franken Amendment, simple, transparent measures of this kind would be used to reward the most accurate rating agencies with additional assignments, while those with the poorest records could, in extreme cases, be suspended or removed from the pool. See Key Questions and Answers, The rating agencies and the Franken Amendment, Demos, June 2010. Available from: http://www.demos.org/publication.cfm?currentpublicationID=F68A14B1-3FF4-6C82-51CF8955309A97FD.

Moreover, there would be similar concerns as the ones related to the trading venues-pays model (option 3). It would be difficult to find the right criteria for attributing rating mandates to individual credit rating agencies. The selecting board would be exposed to civil liability claims. In addition, the establishment and the administration of such a board would be costly and require taxpayers' money.

Option 5 - Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself and introduce mandatory separation between them

The system involving the external rotation of credit rating agencies would prevent conflicts of interest arising from "issuer pays" model and long business relations with rated companies, but would also eliminate "lock-in" effect whereby an issuer has difficulties to switch a rating agency. As issuers would be legally required to change credit rating agencies, this action would not raise concern of investors regarding the creditworthiness of the issuer. This would also help CRAs to better resist any pressure from issuers to issue more favourable ratings by reducing independence threats that result from long business relationship between a CRA and an issuer. Secondly, one could also increase the independence of CRAs by ensuring, where necessary, that a different CRA rates an issuer and its products.

In addition to reinforcing CRA's independence, mandatory rotation of CRAs would also create more opportunities for an issuer to solicit ratings from different CRAs and would offer CRAs the opportunity to rate more different issuers and instruments, potentially gaining more experience in different areas and should give an opportunity for smaller CRAs to compete by producing a track record of quality ratings.

The disadvantages would include a small additional burden on issuers to administer the more frequent change of CRA, and making information available to different parties. For CRAs there may be some additional cost associated with the initial analysis of an issuer or its products in order to issue a rating.

The introduction of external rotation would require reviewing current CRA Regulation requirements on internal rotation for CRAs analysts.

Option 6 - Introduce specific requirements on CRAs' independence and objectivity in relation to their shareholders

A CRA would be prohibited from issuing ratings of any person or of financial instruments issued by a person that owns shares of that CRA or directly or indirectly controls that CRA. Also, shareholders would be prohibited to accrue potentially controlling stakes, individually or in voting blocs in more than one CRA. In view of the potential influence that these persons might have on the management of a CRA, these requirements would remove the potential conflict of interest that a CRA could otherwise have when issuing ratings of these persons.

Moreover, any person that directly or indirectly controls a CRA would be prohibited to invest in products and entities rated by the CRA and to provide advisory services to the entity which or whose products were rated. This requirement would reduce a risk that a CRA is influenced by these persons – individually or jointly – with respect to ratings of financial instruments / issuers that these persons have interest in.

One disadvantage of this option is possible costs for tracking important shareholdings. The CRAs should be aware of their main shareholders whom they also have to report to ESMA during the registration process.[127] A minimum threshold of participation holding in the shareholder's equity of a CRA could be determined to limit the scope of this option to material shareholdings.

[127] See Annex II Nr. 5 of the CRA Regulation.

Option 7 - Strengthen rules on disclosure of rating methodologies

Extend disclosure requirements on methodologies and underlying assumptions of structured finance ratings to ratings of all asset classes

This extension would harmonise requirements between different asset classes and would make ratings clearer to users of ratings. This would also provide for greater stakeholder engagement and would eventually reduce uncertainty in the market regarding the meaning and the quality of a credit rating. It would also reduce overreliance on credit ratings if investors are in a position to better understand and evaluate a rating – and form their own opinion.

Enhance the requirement to disclose material changes in methodologies by additionally requiring the publication of clear reasoning and justification for the changes

This would require CRAs to disclose material changes to their methodologies by publishing detailed justifications and reasoning alongside the changes, disseminating this information especially to all rated entities that would be affected by the changes, as soon as these are known. A requirement to attach such explanations and justifications to any further updates on ratings could also be introduced. This would have the advantage of increasing investors' understanding of the methodologies, enhancing dialogue of CRAs with stakeholders and could potentially also reduce market disruption that rating changes may cause.

Enhance disclosure requirement regarding errors in methodologies or their application by requiring immediate disclosure directly to the affected parties including investors, issuers and competent authorities

If a CRA discovers an error in a methodology or its application the CRA would be required to disclose this directly to the affected parties including investors, issuers and ESMA. Firstly, this would provide incentives to CRA to avoid such errors in the first place. Secondly, this requirement would benefit the market participants by informing them of errors.

Option 8 – Require CRAs to inform issuers sufficiently in advance of the publication of a rating

Option 8 has the advantage over option 1 that it may help to reduce the risk of factual errors before publication of ratings. This option would extend the current pre notification period provided for in Annex I D (3) of the CRA Regulation ("12 hours-rule"). The advantage would be that issuers (including sovereigns) are informed sufficiently in advance of the publication of a rating publication in order to draw the CRA's attention on any factual errors. A notification 12 hours before the publication of a rating, but outside normal working hours, for instance over night, would not be sufficient. Option 8 is favoured by some Member States. Participants who responded to the public consultation had many different views on the time span between informing the issuer and informing the public to be covered under such an option. However, there was a significant perception that 12 working hours would be preferable than a provision of 12 hours without explicitly specifying them as "working hours".

The disadvantage of this option is the potential for negative impacts on market stability due to the greater risk of market abuse / insider dealing before the publication of a rating. However, such risk could be mitigated, by limiting the timeframe to 12 working hours and not 3 working days as suggested in the public consultation and through introducing some safeguards in the forthcoming review of the Market Abuse Directive review. Furthermore, requiring CRAs to inform issuers about rating changes in advance may open room for pressure from the rated entities on the CRAs.

The summary of the analysis of different options to achieve objective 5 (reinforce independence of credit rating agencies and improve ratings quality) is presented in the table

below. The analysis of the impact of these options on different stakeholder groups is given in Annex VIII.

	Effectiveness	Efficiency
Option 1 (baseline)	*n.a.*	*n.a.*
Option 2 **Require investors to pay for ratings ("investor-pays model")**	*(+/-) could help to reduce the issuer-pays conflicts, but may replace these with others or possibly increase investors' reliance on ratings.*	*(-) funding could become more difficult for some types of issuers.* *(+) issuer pays conflicts would be avoided for a section of the market.*
Option 3 **(Require trading venues to set up and ensure the administration of the "Trading venues pay" model)**	*(+) removes issuer-pays conflict.* *(-)does not target non listed financial instruments.*	*(--) cost and difficulty for venues to set up and administer such a model.*
Option 4 **(Require CRA selection to be undertaken by an independent board)**	*(+) the issuer-pays model conflict would be eliminated.* *(--) there could be significantly reduced incentives to compete on quality of ratings depending on specific arrangements of model.*	*(--) potential entrants could face further difficulties establishing themselves in the market.* *(--) cost of developing the independent body.*
Option 5 **(Introduce rotation rules for the CRAs engaged by an issuer**	*(++) reduces incentive for CRAs to inflate ratings in return for repetitive business.* *(-) potential downward effect on rating quality as CRAs incentives to meet highest quality standards may decrease.* *(++) reduces conflicts due to issuer pays model.* *(++) reduces lock in effects.*	*(++)effectively reduces conflicts through relatively simple measures.* *(-) increased costs for issuers/rating agencies.*
Option 6 **(Introduce specific requirements on CRAs independence and objectivity in relation to their shareholders)**	*(++) from the perspective of ownership and control of CRAs,, ensures independence of CRAs and integrity of the market.*	*(+) some additional costs supervision justified by the achievement of this objective.*
Option 7 **(Strengthen rules on disclosure of rating methodologies)**	*(++) ensures that market properly understand and be in a position to scrutinise methodologies for all asset classes.* *(+) in addition it should also reduce overreliance on external ratings.*	*(+) extends existing provisions to cover further asset classes.* *(-) increased costs for CRAs.*
Option 8 **(Require CRAs to inform issuers sufficiently in advance of the publication of a rating)**	*(+) increase quality of ratings by making factual mistakes less probable.* *(-) on the other hand, the requirement to notify issuers about a rating decision in advance opens room for insider dealing/market manipulation.*	*(++)enhance existing provision of CRA Regulation and makes the rating process more transparent without causing further costs.*

Based on the above analysis, the options 5 – 8 score better than other options and are assessed as efficient and effective. The options requiring significant interventions in and alterations of the market (for example, 3 and 4) have potentially prohibitive costs. While they might eliminate some conflicts, they could also engender others. Options 5 – 8 are complementary. Option 7 goes some way to mitigating the concern that option 5 could in some circumstances cause a risk that the quality of ratings could fall: by ensuring transparency, the rating methodologies would be subject to more market scrutiny and encourage CRAs to justify and correctly monitor their ratings. However, the effectiveness of these measures, in particular mandatory rotation of CRAs, can only be ensured if the market conditions are conducive to the growth of small CRAs and the entrance of new players in the rating market.

7. OVERALL IMPACT OF THE PACKAGE

7.1. Cumulative impacts and synergies

This section presents the cumulative impacts from the implementation of the package of preferred policy options. The package of preferred policy options has been developed in a way to ensure the achievement of the overall objective to "*contribute to reducing the risks to financial stability and restoring investor and other market participants' confidence in financial markets and ratings quality*".

The preferred options are expected to reduce overreliance on external ratings by reducing the importance of external ratings in financial services legislation. This is expected to reduce reliance on external ratings by credit institutions[128], insurance undertakings[129], investment funds and the asset management sector.[130] In addition, the preferred policy measure to introduce a requirement for issuers to improve disclosure regarding the underlying asset pools of structured finance products is expected to facilitate investors to make their own credit risk assessment, rather than leaving them to rely solely on external ratings.
Furthermore, the preferred options would improve transparency and quality of sovereign debt ratings through verification of underlying information with a sovereign. A first measure would require CRAs to verify the accuracy of information with sovereigns to ensure that potential errors of sovereign ratings are avoided. Moreover, transparency and quality of sovereign ratings would be enhanced through the publication of the full research report accompanying the rating. The publication of sovereign ratings after closure of European trading venues would ensure that new rating information can reach all market participants and thus would limit major market disturbances. Additionally, to mitigate the risk of contagion effects of sovereign downgrades ESMA, in specific situations determined by the regulation, would be allowed to temporarily ban sovereign ratings. This measure should be temporary, exceptional and subject to very strict conditions.

The preferred policy measures are also expected to improve choice and optimize rating industry structure. Small and medium size rating agencies would be stimulated to exchange information which could facilitate new market entrants entering the rating industry and offer a wide range of services. In addition, comparison of ratings from distinct rating agencies could be facilitated by promoting common standards for rating scales. Furthermore, improved transparency on pricing policies and fees would not only facilitate competition in the rating market, but would also enable ESMA to effectively monitor potential conflicts of interest resulting from the "issuer pays" model. Finally, mandatory rotation of CRAs would not only substantially reduce the familiarity threat to CRA independence resulting from long business relationship between a CRA and an issuer, but would also have a significant positive effect on improving choice in rating industry by providing more business opportunities for smaller CRAs..

In terms of investor protection, the preferred options would ensure that investors have an appropriate right of redress against CRAs before national courts. This would also provide strong incentives for CRAs to comply with legal obligations and ensure high quality ratings.

Independence of ratings would be improved by introducing a requirement for issuers to change CRA periodically. Risks of conflicts of interest would be further reduced by the requirement that a CRA should not be able to rate an issuer and his products simultaneously.

[128] Through an amendment of the Capital Requirements Directive.
[129] Through implementing measures of the insurance regulation II.
[130] Ensured through technical standards and implementing measures subject to extensive scrutiny by ESMA and in cooperation with national competent authorities.

Furthermore, independence would be improved by enhancing the ownership structure of CRAs. In addition, transparency and quality of ratings would be improved by strengthening the rules on disclosure of rating methodologies, by introducing a process for the development and approval of rating methodologies, including the requirement for CRAs to communicate and justify the reasons for modifications to their rating methodologies. Finally, quality of ratings would be enhanced by requiring CRAs to inform issuers sufficiently in advance of the publication of a rating.

7.2. Proportionality of the package

In order to, on the one hand, reduce reliance on ratings and, on the other hand, increase their quality it is necessary to improve transparency and choice for investors and to increase the independence of credit rating agencies.

To achieve the objective of reducing reliance on ratings, the preferred options would ensure that financial institutions are required to enhance internal risk management and promote the use of internal rating models, which would require improved disclosure by rating agencies and issuers. To this end the requirement for issuers to improve disclosure on structured finance products, the most complex financial instruments, on an ongoing basis is necessary to enable internal risk management. The requirement for the publication of the full research report on sovereign ratings also contributes to internal risk management, which is proportionate particularly in view of the important impact of sovereign ratings on financial markets. Disclosure for corporate asset classes remains unchanged.

However, financial institutions of smaller size or with non-complex exposure or private investors would continue to require and use external ratings. This requires availability of a wide choice of ratings based on high quality rating methodologies performed by independent rating agencies.

To improve the choice in rating industry the package proposes to encourage small and medium-sized rating agencies to grow in size and scope by creating a network. These smaller agencies would benefit from improved visibility and comparability through the European Rating Index which would be easily accessible for all interested stakeholders. To ensure comparability of available ratings through the EURIX would require harmonised rating scales based on a technical standard determined by ESMA. To ask rating agencies to provide such rating scales is therefore a proportionate measure.

Additionally, the quality of ratings and the quality of rating methodologies would be improved by a number of measures within the package. Improved disclosure of rating methodologies would improve the understanding of all stakeholders of rating methodologies. For sovereign debt ratings, issuers would be required to inform issuers sufficiently in advance of underlying information used to rate the product which is a precautionary measure to ensure rating quality for sovereigns. Additionally, the requirement to scrutinize rating methodologies of sovereign ratings would be a proportionate additional measure to ensure quality of ratings for this asset class which can have important implications for the stability of financial markets. Furthermore, high quality rating methodologies for sovereigns would contribute to limiting the use of the proposed power, for ESMA, to temporarily ban sovereign ratings. Consequently, it is proposed to limit this latter power to temporary and exceptional that would be subject to very strict conditions.

Concerning the proportionality of the introduction of a rotation requirement it is important to point out that rotation of rating agencies would only apply for "solicited ratings", which are

paid by the issuer. Furthermore, if this requirement were to be introduced, it would be proportionate and consistent to remove the rules on internal rotation of staff for solicited ratings. For (unpaid) unsolicited ratings, the existing requirement to internally rotate staff would need to be maintained to ensure independence for this type of ratings.

Independence would be further reinforced by a prohibition on CRAs rating the products of firms which are themselves controlling shareholders of the CRA. The latter entails an important risk as controlling shareholders could influence rating decisions or exploit preferential information on ratings. This could damage the interests of regular investors. This measure is considered proportionate as the number of controlling shareholders of a CRA is limited. Furthermore, the impact would depend on the activity of the shareholders concerned. Independence will also be reinforced by improved disclosure on prices. To avoid possible collusion in addition to pricing methodologies it is proposed to to disclose aggregate information on fees to the general public. This would enable CRAs clients to better compare prices between CRAs and select CRAs also on the basis of prices. Furthermore, it would be required for CRAs to provide detailed information to ESMA on individual fees. This information would enable ESMA to enforce the practical application of non-discriminatory fees by CRAs. Moreover, pricing on basis of the actual costs would reduce conflicts of interest due to the "issuer pays model" and thus strenghten independence of rating agencies.

7.3. Impact on different stakeholders groups

i) *Investors* confidence in financial markets is expected to improve as a risk of "cliff" effects on financial institutions would be mitigated. Furthermore, investors would benefit from enhanced transparency which would increase their capacities to determine their own credit assessment without relying solely on external credit ratings. Furthermore, investors would benefit form better understanding of sovereign ratings, improved choice in the rating market and improved independence of rating agencies. Finally, investors would benefit from the improved possibilities of civil liability in case of infringements of the CRA regulation.

ii) *Financial institutions* would gain comfort that both enhanced credit risk management systems and external credit ratings would mitigate exposures, but would need to adapt their systems and processes to ensure compliance. Furthermore, they would benefit from enhanced transparency of rating methodologies.

iii) *Corporate and structured finance issuers* would benefit from increased independence of CRAs ensuring that their debt instruments are rated with high quality methodologies and would benefit from improved understanding of ratings by investors. However, issuers would need to change rating agency periodically to ensure compliance. Issuers of structured finance products would need to enhance transparency to investors on underlying asset pool.

iv) *Sovereign issuers* would benefit from improved communication between CRAs and sovereigns avoiding eventual errors in underlying information which would contribute to high quality sovereign ratings. Furthermore, sovereigns would benefit from reduced risks of market disruption in case of sovereign downgrades due to better understanding of sovereign risks among investors.

v) *CRAs:* would need to comply with a range of policy measures. First of all they would need to comply with increased transparency and of sovereign debt ratings.

In addition, CRAs would be subject to more harmonised civil liability rules. Moreover, CRAs independence would be enhanced through additional requirements on CRAs' ownership and remuneration. Finally, increased transparency of rating methodologies would mean enhanced communication with investors, issuers and supervisors which would eventually increased ratings quality.

- *Small and medium-sized rating agencies* would benefit from enhanced market conditions and would find it easier to establish themselves on the market, particularly due to the requirement for issuers to change rating agencies periodically. Furthermore, they would benefit from the exchange of information when participating in the network of small and medium sized agencies and from increased visibility through common standards on rating scales. Over time this could contribute to having more competitors in the rating market providing and a wider range of services. Small and medium-sized rating agencies would benefit from increased visibility through a EURIX.

- *Large CRAs* are likely to face more competition in the market due to a requirement for issuers to change periodically their rating agency. They would also face more competition due to increased transparency and the ban on price discrimination.

vi) *Supervisors (ESMA)* would benefit from more increase supervisory powers to scrutinize rating methodologies and to temporarily ban sovereign ratings in case of specific situations. However, ESMA would need to adapt their supervisory processes to ensure that all new rules are applied.

7.4. Assessment of administrative burden and compliance costs

The table below provides for administrative burdens and other compliance costs for individual preferred options that aim to reduce the overreliance on external credit ratings, to mitigate the risks of contagion effects of sovereign debt ratings, to promote competition in the credit-rating market, to ensure the right of redress for investors and to enhance independence of CRAs. It should be noted that administrative burdens are those compliance costs that result from meeting legal obligations to provide information to public authorities or to private parties.

Policy Areas	Preferred Options	AVERAGE COMPLIANCE COSTS			of which: ADMIN BURDEN	
		One-Off	recurring		One-Off	recurring
			Low	High		
		MLN €	MLN €	MLN €	MLN €	MLN €
OVERRELIANCE	Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes	0,00	substantial	substantial	0,00	0,00
	Improve disclosure requirements for issuers of structured finance products on an ongoing basis	1,70	1,92	1,92	1,70	1,92
SOVEREIGN	Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff	0,00	5,21	5,21	0,00	0,01
	Require CRAs to publish sovereign ratings after closing of EU trading venues	0,00	0,00	0,00	0,00	0,00
	Require CRAs to conduct the sovereign debt ratings process more frequently	0,00	3,12	3,12	0,00	0,00
	Extend powers of competent authorities (ESMA) to scrutinize rating methodologies	0,00	0,15	0,15	0,00	0,00
	Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in exceptional situations	0,00	0,00	0,00	0,00	0,00
COMPETITION	Encourage the emergence of a network of small and medium size rating agencies	0,00	0,90	1,95	0,00	0,00
	Harmonise ratings scales to improve comparability of ratings between CRAs	1,08	0,00	0,00	0,00	0,63
	Establish a European Rating Index (EURIX)	0,30	0,45	0,45	0,00	0,38
	Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs	0,00	0,03	0,03	0,00	0,03
CIVIL LIABILITY	Ensure civil liability of CRAs towards users of credit ratings in civil law of Member States	0,00	substantial	substantial	0,00	0,00
INDEPENDENCE	Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself and in introduce mandatory separation between them	0,00	0,01	0,01	0,00	0,01
	Introduce additional and specific requirements on CRAs' independence and objectivity in relation to their shareholders	0,00	0,01	0,01	0,00	0,00
	Strengthen rules on disclosure of rating methodologies	0,00	0,00	0,00	0,00	0,00
	Require CRAs to inform issuers sufficiently in advance of the publication of a rating	0,00	0,00	0,00	0,00	0,00
	TOTAL :	**3,1**	**11,8**	**12,8**	**1,7**	**3,0**

The full explanation of the methodology, assumptions and calculation of the administrative burden and compliance costs can be found in annex XII.

There would be additional costs for financial firms resulting from the requirements to enhance internal risk management and the use of internal rating models for regulatory purposes. These costs would be substantial for relevant financial sectors as a whole, but proportional with respect to individual financial firms. There would also be additional costs to issuers due to enhanced disclosure requirements, the total of which could amount to EUR 1.7 million one-off cost and EUR 1.92 million annually.

A set of options to mitigate risks of contagion effect linked to sovereign ratings, would lead to some additional compliance costs to CRAs, which could amount to EUR 3.27 million annually to the industry.

Measures to improve competition would not significantly increase the costs for CRAs (the annual compliance cost of the rating industry is expected to be around 1.38 Million). The costs would only relate to promoting the emergence of a network of small and medium sized CRAs (see Annex X) that could range annually between €0.9 to 1.95 million, for which the Commission would explore possibilities for EU funding/instrument.

The policy option related to civil liability of CRAs towards investors is expected to cause compliance costs due to need to insure their civil liability or, in the absence of the insurability, to create a financial buffer to cover potential claims from investors.

Finally, the preferred options dealing with CRA independence are not expected to entail any significant costs.

7.5. Impact on EU budget

Only the policy measure to introduce a network of small and medium rating agencies is expected to affect the EU Budget. However, this policy measure would rely on existing programmes. Therefore, these policy measures would not have an impact on the EU budget.

All other preferred policy measures, including additional powers granted to ESMA have already been covered by the existing EU budget.

7.6. Impact on fundamental rights

An assessment was made of the policy options to ensure compliance with fundamental rights.[131] Most of the options considered in this impact assessment have no relevant impacts on fundamental rights. By ensuring a better regulation and reliability of the service provided by the CRAs to businesses and individuals, the measures generally impact positively on the right to consumer protection and the freedom to conduct business.

As far as the Credit Rating Agencies' freedom to conduct a business (Article 16 Charter of Fundamental Rights of the European Union) is concerned, the preferred option would lead to more effective and harmonised regimes for provision of financial risk management and CRAs activities with the objective of improving financial stability and compliance with CRA Regulation rules, in line with the principle of proportionality. In particular, as regards sovereign debt ratings, the preferred option - providing for powers to temporarily restrict or ban sovereign debt ratings in clearly defined exceptional circumstances, thus avoiding arbitrariness,-appears as a less intrusive means compared to a blanket and general prohibition of issuing sovereign debt ratings. One could argue that this option restricts, to some extent, the freedom of expression or information (Article 11 Charter of Fundamental Rights of the European Union) of credit rating agencies. However, limitations to this right are possible, in accordance with Article 10(2) of the Convention for the Protection of Human Rights and Fundamental Freedoms as referred to by Article 52(3) of the Charter. Article 10(2) of that Convention provides that the exercise of the freedom of expression carries with it duties and responsibilities and may be subject to restrictions prescribed by law necessary for, *inter alia*, the prevention of disorder. Indeed, the objectives of general interest pursued by the prohibition to issue sovereign ratings or review of existing ones are covered by the concept of prevention of disorder referred to in Article 10(2) of that Convention. By ensuring a right of redress and access to justice to businesses and individuals having suffered loss due to actions that may give rise to civil liability by CRAs, the preferred option impacts positively on the right to an effective remedy and to a fair trial in line with Article 47 of the Charter of Fundamental Rights.

As regards data protection (Article 8 of the Charter and Directive 95/46/EC on the processing of personal data) the proposal would ensure that if personal data are processed in any way such processing would be carried out in line with the Charter and Directive 95/46/EC.

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[131] Based on (COM (2010) 573), Strategy for the effective implementation of the Charter of Fundamental Rights by the European Union, October 2010, particularly the check list.

7.7. Social impact

The framework proposed is expected to reduce risk to financial stability. As far as the options considered in this initiative would mitigate the frequency or the duration of future financial crises and their impact on the real economy, they would also reduce the social costs of these crises, mainly through a lower level of unemployment.

7.8. Environmental impact

The proposal would not have any direct or indirect impacts on the environment.

7.9. Impact on SMEs

The proposals would affect two types of SMEs: CRAs that are SMEs and SMEs wishing to be rated. The proposal takes into account the size of firms. For example, as the planned obligation for financial institutions to develop internal models to assess credit risk would not apply to SME financial institutions without material, complex credit risk exposures. Those however that did have material, complex exposures would need to reduce their reliance on external ratings. However, the problem of distinguishing complex and material exposures from immaterial exposures remains to be resolved.

In the case of CRAs that are also SMEs, a network of smaller CRAs would help them develop by promoting best practice and experience. However, due to existing economies of scale and reputation in the rating sector, the effectiveness of a CRAs network to stimulate competition with large CRAs may be limited. Development of SME CRAs could also be stimulated if issuers were required to rotate between CRAs, as more rating opportunities would be created for smaller CRAs.

The proposals regarding civil liability of CRAs towards investors affect SME CRAs equally with larger CRAs. Both SME and large CRAs would be subject to civil liability. The large CRAs would indeed be more exposed to civil liability claims due to the size of the rated firms and larger value of the rated debt instruments, their wide range of ratings provided and their market presence and reputation. SME CRAs, on the other hand, generally rate smaller firms and debt instruments of smaller value. They also usually have a much smaller market presence in terms of territorial aspects, asset classes and reputation among investors. Therefore they are likely to be less affected by civil liability claims. Furthermore, it should be stressed that civil liability would be imposed upon large and SME CRAs only in case of gross negligence or intent on their part. SME CRAs can therefore avoid liability by taking precautionary measures. Lastly, SME CRAs can also insure their liability with proportionately lower costs since their ratings are, as stressed above, generally related to smaller money values.

Finally, the proposals in this impact assessment would not affect the competitiveness of SMEs in general as it would contribute and help SMEs to make sustainable decisions for investments while relying less on ratings by making their own due diligence assessments and evaluations of the ratings issued.

7.10. Coherence with other proposals

This proposal is in strong relation with other policy initiatives in the EU. A detailed list of the main legislative initiatives and analysis of the coherence with the legislative initiative CRA3 is presented in the Annex XIII.

The Commission services are coordinating their different exercises to make sure that they are based on compatible data and models.

7.11. Choice of legal instrument

The current initiative encompasses a wide range of measures. They can be divided in five categories.

Measures requiring amendments to the current CRA Regulation

A first group of proposed measures strengthen and build on provisions in the current CRA Regulation.

Measure	Relevant section
Requirement to publish full research reports on sovereign debt ratings and disclose the allocation of staff	section 6.2, option 2
Requirement to publish sovereign ratings after closing of EU trading venues	section 6.2, option 3
Requirement to conduct the sovereign debt rating process more frequently	section 6.2, option 4
Enhanced disclosure requirements for rating methodologies	section 6.5, option 7
Extending the powers of ESMA to scrutinize rating methodologies and temporarily ban sovereign debt ratings	section 6.2, option 7
Requirement to disclose pricing of ratings and prohibit price discrimination	section 6.3, option 9
Requirement to regularly rotate the CRA	section 6.5, option 5
Provisions to mitigate conflicts of interests related to the shareholder structure	section 6.5, option 6
Requirement for a CRA to inform an issuer sufficiently in advance of a rating change	section 6.5, option 8

Implementation of those measures would require amendments to the current CRA Regulation. They could not be achieved by non binding measures (e.g. ESMA guidelines) as those rules need to be enforceable by ESMA in order to be effective. More specifically, one group of the proposed amendments to the CRA Regulation complement or extend the application of provisions included in the current CRA Regulation. This refers to all requirements related to transparency and enhanced disclosure (publication of a full research report, publication of ratings outside trading hours, requirements related disclosure of methodologies, communication with the issuer in advance of a rating change), the rating process (frequency of the rating process), prevention of conflicts of interest and corporate governance requirements (rotation of CRAs, shareholder structure). Consequently, an amendment in form of a Regulation is necessary.[132]

Enhancing ESMA's powers to scrutinize in more detail or temporarily ban sovereign debt would also require a change to the current CRA Regulation. Enforcement measures can only be based on a binding legal act according to the rule of law.

The proposed requirement to disclose pricing and prohibit price discrimination would also require an amendment to the CRA Regulation. A recommendation through an ESMA guideline would not be sufficient as in this case it would not be certain that all CRAs comply

[132] This applies to the requirement to publish full research reports on sovereign debt ratings and disclose the allocation of staff which will complement Articles 10, 11, Annex I section D I 2 and section E III 3 of the CRA Regulation; - the requirements to publish sovereign ratings after closing of EU trading venues which builds on Article 10 (1) of the CRA Regulation; -the requirement to conduct the sovereign debt rating process more frequently which enhances Article 8 (5) of the current CRA Regulation; - enhanced disclosure requirements for rating methodologies which specifies Article 10, Annex I D 2 (b) of the CRA Regulation; -the requirement to regularly rotate the CRA which builds on Article 7 (4) of the CRA Regulation; -provisions to mitigate conflicts of interests related to the shareholder structure which concretize Article 6 (2), Annex I Section B, 3,4 of the CRA Regulation; - the requirement to inform an issuer sufficiently in advance of a rating change which enhances Article 10, Annex I Section D I 3 of the CRA Regulation.

with the rule which would jeopardize the effectiveness of the measure and cause an unlevel playing field.

Measures requiring amendments to the current CRA Regulation coupled by technical standards

Three measures would require a change of the CRA Regulation including an empowerment of ESMA to prepare draft technical standards. These are:

- requirements for CRAs to use a harmonised rating scale and to report rating information to the European Rating Index (section 6.3, option 4 and option 5);
- specifying the content and format of periodic reporting on fees charged by credit rating agencies (section 6.3, option 9);
- disclosure requirements for issuers of structured finance instruments (section 6.1, option 6).

These proposed measures could not be achieved by non binding measures (e.g. ESMA guidelines) as they need to be enforceable by ESMA in order to be effective. A harmonised rating scale makes only sense if it is strictly applied by all CRAs. Therefore, a simple recommendation would not be sufficient. Similarly, disclosure requirement with regard to structured finance products need to be applied by all issuers in order to be effective. Otherwise the objective to allow investors to assess and compare different instruments could not be met.

Details of the proposed measures (the detailed calibration of the harmonised rating scale, details of the information to be disclosed by issuers) could be determined by regulatory technical standards (to be drafted by ESMA) as they are technical and do not imply policy choices which would be determined by amendments to the CRA Regulation.

Measures requiring amendments to the current CRA Regulation	Field	Legal instrument	Preliminary timeline
• Policy measures to mitigate the risks of "cliff" and contagion effects linked to sovereign debt ratings • Policy measures to improve credit rating market conditions (except, a policy option to support the small and medium sized CRAs network) • Policy measures to ensure right to redress for investors • Policy measures to reinforce independence of credit rating agencies	Credit Rating Agencies	Amendments of CRA Regulation (CRA III)	Proposal to be adopted Q4 2011

Measures requiring amendments to sectoral legislation

The proposed measures to reduce reliance on credit ratings, require changes to sectoral financial legislation. The amendments regulate to what extent financial firms may or may not use external ratings, that financial firms have to carry out their own credit risk management and which alternatives to ratings should be used. Requirements on financial firms are in general regulated in the respective sectoral financial legislations. However, a comprehensive

provision could be included in the CRA Regulation preventing financial firms from over-relying on credit ratings.

In addition, a sectoral approach should be chosen as any alternatives to external ratings have to be specific to the sectoral context where external ratings are being used. This sectoral approach is also followed by the US SEC.[133]

More specifically, it would be necessary to implement the measures against overreliance in sectoral legislation for credit institutions and investment firms (where relevant modifications have been included in the proposal for amendments to the Capital Requirements Directive (CRD IV) of 20 July 2011), for insurance and reinsurance undertakings and in the investment management sector.

Measures against overreliance	Field	Legal instrument	Preliminary timeline
• Strengthening own internal risk management of financial firms • Requiring firms with material credit risk exposure to develop internal models (applies to credit institutions, investment firms and insurance and reinsurance undertakings) • Regular reporting by ESAs on efforts by firms and supervisors to reduce risk of overreliance	Credit institutions and investment firms	CRD IV-Banking Directive/Regulation	Proposal adopted on 20 July 2011
	Insurance and reinsurance undertakings	Solvency II framework Directive (Omnibus II) Implementing measures	Currently negotiated in Council/Parliament Summer 2012
	Alternative investment fund managers	AIFM Directive Implementing measures (tbd)	Summer 2012
	Investment managers	Technical standards of UCITS Directive (tbd)	Summer 2012 (to be confirmed by ESMA which has the right of initiative in this regard

In the remaining areas of financial regulation where ratings are referred to[134] changes to sectoral legislation should be proposed where these references have the potential to trigger undue reliance on ratings. Any changes would be subject to a separate impact assessment.

Measures building on an existing European Union funding program

In order to enhance competition on the market for rating services and lower entry barriers for small players it is proposed to support the establishment of a network among small/medium CRAS to share best practices and develop capacity (section 6.3, option 3). Such a network would require Union funding and thus would need an adequate legal basis in a Union legal act (usually decision or regulation). Taking into consideration, on the one hand, constraints in Union financing and, on the other hand, that funds could possibly become available by using existing Union programmes, this network could be supported making recourse to one of the two instruments under which the actions of the existing CIP (competitiveness and Innovation Framework Programme) will continue as from 2014 onwards[135], i.e.:

- the common strategic framework for research and innovation funding, called 'Horizon 2020";
- the new Competitiveness and SME programme for the continuation of the non-innovative actions of the CIP mentioned above.

[133] US SEC Report on the Review of Reliance on Credit Ratings, July 2011.

[134] See complete list of references to external ratings in EU financial Regulation in Annex IV 2.1.

[135] See the multiannual financial framework 2014-2020 "A budget for Europe 2020" COM (2011) 500 final of 29.6.2011.

The identification of the programme which would fit the best the funding of the proposed network will be done at a later stage when all the details of the two instruments mentioned will be known.

Measures on an existing EU funding program	Field	Legal instrument	Preliminary timeline
• Enhance competition on the market for rating services	Establishment of a network among small/medium CRAs	CIP – independent initiative/program	Programme could be adopted in course of 2012

Measures requiring changes to the CRA Regulation and implementation in national legal orders

In order to ensure civil liability of credit rating agencies vis-à-vis investors non-binding rules would not be effective. This could result in a situation where investors in some Member States would not be enabled to engage in civil liability claims against a CRA that has violated the CRA Regulation thereby causing damage to the investor. Therefore, only binding legislative instruments would be appropriate. The proposed amendment of the CRA Regulation[136] would ensure civil liability of CRAs vis-à-vis investors exist and is effective according to the national civil law orders (section 6.4. option 3).

Measures to ensure right of redress for investors	Field	Legal instrument	Preliminary timeline
• Ensure civil liability of CRAs towards users of credit ratings in civil law of Member States	Credit Rating Agencies	Amendments of CRA Regulation (CRA III)	Proposal to be adopted Q4 2011

7.12. Impact on third countries

The proposed policy measures against overreliance shall implement in the EU legal order the FSB's principles to reduce the reliance on ratings, as requested by the FSB in October 2010. Following the FSB principles, other jurisdictions and international standard setters, including the US and the Basel Committee on Banking Supervision (BCBS), are also taking measures against overreliance. Compliance with the FSB principles and coordination by international standard setting bodies should ensure international consistency of these measures.

Also most of the other areas that the proposed measures would strengthen are currently reviewed and enforced by third country regulators, including the US. For instance, the US SEC is currently investigating ways to reduce conflicts of interests due to the issuer-pays model. Measures to improve disclosure of structured finance instruments, to increase competition in the rating market and to strengthen civil liability of CRAs have already been taken in the US.

[136] It was assessed that the CRA Regulation would be more appropriate legal instrument versus Directive. It is neither legally necessary nor practical and proportionate to propose an extra directive for the single provision that we have in mind on civil liability. According to the settled case-law of the ECJ (Eridania, judgement of 27.9.1979 – case 230/78) the fact that a regulation is directly applicable does not prevent the provisions of that regulation from requiring Member States to take implementing measures. For instance, Art 36 of the first CRA Regulation (2009) required Member States Member to "…lay down the rules on penalties applicable to infringements of the provisions of this Regulation and … to take all measures necessary to ensure that they are implemented".

If following this IA the EU regulatory regime on CRAs was enforced, this would have to be considered in subsequent equivalent assessments according to Article 5 (6) and also by ESMA when deciding on whether a third country regulatory regime can be considered as stringent as the EU regulatory framework according to Article 4 (3) of the CRA Regulation. Ratings from third country CRAs can only be endorsed if the third country CRA complies with requirements of the third country regulatory regime being as stringent as the EU CRA Regulation. Given the proportionality of the proposed measures and the fact that third countries are also enforcing the relevant areas, we do not assume that the proposed measures would make the access of third country CRAs to the EU much more difficult.

On the other hand, third country CRAs would also benefit of access to more information due to increased disclosure, especially for structured finance issues, which would allow CRAs to compete with solicited ratings by issuing their own ratings.

For third country investors there would be the added benefit of being able to use ratings issued by CRAs subject to enhanced transparency and procedural requirements. Establishing liability of CRAs towards investors would also allow third country investors to benefit from this added investor protection if enacted. Successful adoption of measures to increase competition could also see a greater choice in ratings for investors. Finally, third country investors would benefit from increased disclosure regarding structured finance instruments, allowing them to further improve their own credit risk assessments.

For issuers in third countries, there may be the possibility of soliciting ratings by a greater number of CRAs subject to a high level of oversight. Both issuers and investors stand to benefit from increased independence and transparency of CRAs and the resulting improvement in the quality of ratings.

Market participants in general should benefit from a reduced risk of negative impacts of sudden ratings corrections, flawed ratings and inappropriate sovereign ratings and potentially negative market consequences.

8. MONITORING AND EVALUATION

When the recommended policy options are put into practice, the Commission will monitor how Member States apply the proposed policies. When necessary, the Commission will pursue the procedure set out in Article 226 of the Treaty in case any Member State fails to respect its duties concerning the implementation and application of Union Law.

In order to assess the effectiveness of the proposed policies, the Commission will propose to set up the following system of monitoring to facilitate an evaluation three years after the transposition date (possibly in the form of a report to the Council and the Parliament).

As part of the monitoring exercise, ESMA would receive quarterly reports from national competent authorities on the various policy areas. The evaluation would be built on this information. The main indicators and sources of information that could be the following:

- Regarding the measures designed to increase the number of unsolicited ratings issued: *The number or proportion of solicited and unsolicited rating issued for various asset classes*.
- To monitor the 'stabilisation' of sovereign ratings: *The frequency of review and issuance of ratings, particularly sovereign debt ratings.*
- To assess the achievement of better transparency and use of rating methodologies: *Frequency and types of changes to methodologies, and how often these were rejected or challenged.*

- To assess the effectiveness of increasing new market entry: *The number of new entrants and changes to the market structure.* This could include market share of existing players in terms of both revenue and number of outstanding ratings in various classes.
- As regards reliance on ratings, a report on *the use of the standardised and internal ratings based approaches* could investigate impact of the use ratings for regulatory purposes by firms.

In other areas, such as liability of CRAs, it may be difficult to assess the impact of proposals three years after transposition, as case law developments are likely to take more time.

ANNEX I. OVERVIEW OF EXISTING CRA REGULATION AND POSSIBLE NEW INITIATIVES ON CRAS (PREFERRED OPTIONS)

<table>
<tr><th>CRA I + CRA II reference</th><th>CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)</th><th>New initiatives (in addition to CRA Regulation)</th><th>Instrument where new policy will be included</th></tr>
<tr><td colspan="4">REGISTRATION – SUPERVISION – ENFORCEMENT POWERS

ESMA is in charge of registering and supervising credit rating agencies in the EU from 1 July 2011. ESMA has to ensure that the CRA Regulation is correctly applied by CRAs. If a CRA does not comply with the CRA Regulation, ESMA has to take supervisory measures and impose a fine on the CRA.</td></tr>
<tr><td>Art. 14-17 of CRA Regulation[137]

Art. 21-23d

Art. 24, 36a,

Art. 19

Art. 40, 40a</td><td>Registration and supervision: CRAs must apply to register with ESMA, which will decide on each application.

Supervision: ESMA will supervise the CRAs in order to ensure compliance with the requirements of the CRA Regulation. ESMA's supervisory powers include information requests and on-site inspections. ESMA can delegate specific supervisory tasks to competent authorities of the Member States.

Sanctions: ESMA can take supervisory measures (up to the withdrawal of the registration) against a CRA infringing the CRA Regulation and can also impose fines.

Fees are levied from CRAs to pay for the supervision.

Transitional regime

-According to the CRA Regulation ESMA is in charge of supervising all registered CRAs from 1 July 2011.
- From 1 July 2011 any new applications from CRAs are to be decided by ESMA
- Applications from existing CRAs (those that have been operating in the Union before 7 June 2010) had to be submitted by 7 September 2010; their examination will be finalised by colleges composed of national competent authorities. ESMA is involved in the registration process but the final decision is taken by</td><td></td><td></td></tr>
</table>

[137] Regulation 1060/2009 on credit rating agencies as amended by Regulation 513/2011.

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
	national competent authorities.		
CORPORATE GOVERNANCE A CRA should maintain arrangements for sound corporate governance which shall ensure that the CRA issues ratings that are independent, objective and of good quality.			
Annex I.A.9	**Rating policy review function:** An internal function to review the methodologies, models and significant changes to methodologies and models. This function should be independent of the business lines and report to the independent members of the board.		
Annex I.A.5-6	**Compliance function:** A permanent and effective compliance function operating independently of the business lines is required. It reports regularly to senior management and the independent members of the board.		
Annex I.A.2	**Independent members of the administrative or supervisory board:** At least 1/3 but not less than 2 independent members required. They have the specific task of monitoring the development of the rating policy and methodologies, effectiveness of the rating internal quality systems, effectiveness of procedures dealing with conflicts of interest, compliance and governance processes.		
CONFLICTS OF INTERST Conflicts of interest have to be identified and either eliminated or properly managed and disclosed. Conflicts of interests arise for instance from remuneration models used by CRAs, from the provision of advisory or ancillary services and from CRAs, its staff or important shareholders having an own interest in the rated instruments.			
Art. 6, Annex I B 1	**General policy:** CRAs to ensure that conflicts of interest will not affect ratings. Actual or potential conflicts of interest to be (i) identified and either (ii.1) eliminated or (ii.2) properly managed and disclosed.		
Annex I.B.3	**Prohibited conflicts of interest:** Ratings not to be issued and existing, potentially compromised ratings to be immediately flagged as such.		

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
Annex I.B.4	**Prohibition of provision of consulting/advisory services:** It is prohibited to provide consulting/advisory services to the rated entity or its related third party.		
Annex I.B.4	**Provision of ancillary services:** Only specific ancillary services may be provided (market forecasts, estimates of economic trends, pricing analysis and other general data analysis as well as related distribution services). CRA to ensure that ancillary service does not present a conflict of interest with the rating activity and to disclose in the final ratings report any ancillary services provided to the rated entity.		
Art. 7(5)	**Compensation and performance evaluation of analysts:** Compensation and performance evaluation of analysts not to be contingent on the amount of revenue generated.		
Art. 7(2)	**Rating staff engagement in fee negotiations:** Prohibited.		
Annex I.C.1, 3, 4, 6.	**Rules on conduct of the staff engaged in the rating process:** Prohibition for the rating analysts and person approving the ratings to engage in any transactions in instruments related to the rated entity. Prohibition to accept money, gifts or favours from anyone the CRA does business with. Handling of confidential information (incl. unpublished ratings). Look-back reviews of ratings after an analyst has left to work for the rated entity.		
Annex I.C.2	**Rules excluding employees from the rating process:** Prohibition for the rating analysts and persons approving ratings to be engaged in rating an entity triggered by conflicts of interest arising from owning financial instruments, recent employment, business or other relationship.		
Art. 7(4), Annex I.C.8	**Rotation of rating staff** is mandatory. Lead analysts to rotate every four years, ratings analysts every five years, and persons		

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
	approving ratings every seven years.		
		Rotation of CRAs: An issuer's own credit worthiness **could not be rated by the same CRA for more than 3 consecutive years.** Another CRA would take over thereafter and the outgoing CRA and the issuer would make available all information accessed in the rating process. A CRA would **not be able to rate more than 5 consecutive issues** of any asset class by the same issuer, or if fewer than 5 issues are made, it would not be able to rate the issues of one issuer over a period exceeding 3 years.	CRA III – Q4 2011
		Introduce additional requirements on **CRAs' independence and objectivity in relation to their shareholders**. ESMA would be required to ensure that: (1) shareholders could not either individually or in voting blocs accrue potentially controlling stakes in more than one CRA (2) CRAs could not issue ratings for any firm that has a significant shareholding of that CRA, even indirectly (3) a firm that has a significant shareholding in a CRA would not be allowed to invest in products rated by this CRA.	CRA III – Q4 2011
ENSURE THE QUALITY OF RATINGS AND OF RATING METHODOLOGIES CRAs are required to monitor ratings in order to keep them up to date. The information used by CRAs to produce ratings has to be of sufficient quality, where this is not the case CRAs have to refrain from issuing ratings. Finally, rating methodologies have to comply with certain qualitative requirements. Supervision by ESMA will be strengthened in this respect.			
Art. 8(5)	**Monitoring activity:** Monitoring of ratings required on an on-going basis (as well as at least an annual review).		
Art. 8(6)	**Impact of methodology changes on existing ratings:** When a methodology, model or key rating		

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
	assumption is changed, a CRA shall: (a) immediately, using the same means of communication as used for the distribution of the affected credit ratings, disclose the likely scope of credit ratings to be affected; (b) review the affected credit ratings as soon as possible and no later than six months after the change, in the meantime placing those ratings under observation; and (c) re-rate all credit ratings that have been based on those methodologies, models or key rating assumptions if, following the review, the overall combined effect of the changes affects those credit ratings.		
Annex I.D.I.4	**Quality of data used:** A CRA shall state clearly and prominently when disclosing any credit rating whether it considers satisfactory the quality of information available on the rated entity and to what extent it has verified information provided to it by the rated entity or its related third party.		
Annex I.D.I.4	**Limits to rating activity:** CRAs shall refrain from issuing a rating or withdraw an existing rating when (i) lack of robust data, (ii) complexity of the structure of a new instrument or (iii) quality of information is not satisfactory or raises serious questions as to whether a credible rating can be produced.		
Annex I.D.II.2	For **structured finance instruments**, a CRA is expected to state what level of assessment it has performed concerning the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments.		
Art. 8(3) CRA Regulation	**A credit rating agency shall use rating methodologies** that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-		

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
	testing.		
		Requiring registered CRAs to **notify in advance any change of rating methodologies**. Only after a positive assessment by ESMA the CRA may proceed with the new methodology.	CRA III – Q4 2011
		ESMA shall be empowered **to restrict for a limited period the issuance of ratings** where a sovereign requests financial support by the EFSF.	CRA III – Q4 2011
Art. 23(1)	**Principle of non interference:** Prohibition for ESMA or any other public authority to interfere with the content of credit ratings or methodologies.		
TRANSPARENCY – DISCLOSURES The CRA Regulation sets various disclosure and transparency requirements in order to allow investors and issuers to properly understand rating actions and supervisors to assess the rating activity. Rules on the timing of rating publications shall ensure that all market participants are informed at the same time.			
Art. 10(1)	Disclosure of credit ratings: Any credit rating should be **disclosed on a non-selective basis and in a timely manner** (also applicable to credit ratings distributed by subscription)		
		Require CRAs **to publish sovereign debt ratings only after the close of business of European trading venues** ensuring that all market participants can obtain a full understanding of any change of a rating.	CRA III – Q4 2011
Art.8(1), Annex I.E.I.5 Annex I D I 2 b	**Disclosure of methodologies, models and key assumptions in use:** CRA required to disclose on an on-going basis the methodologies, and descriptions of models and key rating assumptions such as mathematical or correlation assumptions used in its credit rating activities as well as their material changes. Also the CRA has to indicate the		

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
	principle methodology that was used in determining a specific rating.		
Annex I D II 1-4	**Disclosure obligations in relation to credit ratings of structured finance instruments**: 1. provide in the credit rating all information about loss and cash-flow analysis; 2. level of assessment it has performed concerning the due diligence processes carried; 3. accompany the disclosure of methodologies, models and key rating assumptions with guidance which explains assumptions and uncertainties of the models used; 4. disclose, on an ongoing basis, information about all structured finance products submitted to it for their initial review or for preliminary rating.		
		Extend the requirement to disclose methodologies and underlying assumptions behind ratings **from structured finance products to all asset classes.** Require the **publication of clear reasoning and justification for changes of rating methodologies**. **Disclose errors in methodologies or their application** by requiring immediate disclosure directly to the affected parties including investors, issuers and competent authorities.	CRA III – Q4 2011
Art. 10(3)	**Differentiation of structured finance ratings:** When a CRA issues credit ratings for structured finance instruments, it shall ensure that rating categories that are attributed to structured finance instruments are clearly differentiated using an additional symbol which distinguishes them from rating categories used for any other entities, financial instruments or financial obligations.		
Annex I D (3)	**The credit rating agency shall inform the rated entity at least 12 hours** before publication of the credit	CRAs to inform issuers and **specifically sovereigns** for which they are in the process of	CRA III – Q4 2011

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
	rating and of the principal grounds on which the rating is based in order to give the entity an opportunity to draw attention of the credit rating agency to any factual errors.	issuing a rating sufficiently in advance (**12 working hours**) of the publication of the rating, of the principle grounds on which the rating is based.	
Annex I.E.III.(3)	A credit rating agency shall make available annually statistics **on the allocation of its staff** to new credit ratings, credit rating reviews, methodology or model appraisal and senior management.	In addition, require CRAs to publish information on the **allocation of staff to ratings of different asset classes**.	CRA III – Q4 2011
Art. 11(2), Annex I.E.II.1	**Historical performance data**: CRAs to make available every six months in a central repository established by ESMA information on its historical performance data including the ratings transition frequency and information about credit ratings issued in the past and on their changes. .		
		CRAs would be required **to publicly disclose the actual prices and the pricing methodology** of their ratings services. CRAs will also have to ensure that the prices and fees they charge for their services are (a) not discriminatory, i.e. fully based on the costs; (b) not based on any form of contingency.	CRA III – Q4 2011
		Harmonised rating scale to be set by ESMA, including a common definition on sovereign default.	CRA III – Q4 2011
		Disclosure requirements for issuers of structured finance products will be on an ongoing basis, enabling the disclosure of the main elements of underlying asset pools for structured finance products necessary for investors to make their own credit assessment and thus not rely on external ratings. Issuers will disclose this information by means of a website.	CRA III – Q4 2011
OVERRELIANCE ISSUES OUTSIDE CRA REGULATION			
Enhanced internal risk management		Credit institutions, investment firms, insurance and reinsurance	CRD IV – July 2011; Solvency II

CRA I + CRA II reference	CRA I (Regulation 1060/2009) and CRA II (Regulation 513/2011)	New initiatives (in addition to CRA Regulation)	Instrument where new policy will be included
		undertakings, asset managers and investment funds' investment decisions must not rely solely and mechanistically on ratings but always form their own internal credit opinion on every exposure.	– Q1 2012; UCITS and AIFMD – Q2 - 2012
	Internal ratings based approaches to calculate capital requirements	Institutions with a material number of exposures in a given asset class will need to develop internal models.	CRD IV – July 2011; Solvency II – Q1 2012
	Verify external ratings internally	Even if institutions do not use internal ratings they will be required to compare their internal credit opinion with the capital requirement resulting from an external rating.	CRD IV – July 2011; Solvency II – Q1 2012
SOVEREIGN DEBT RATING ISSUES OUTSIDE CRA REGULATION			
	ECB and ESM	Encourage the ECB or ESM to establish independent credit assessments, particularly for European sovereigns and systemic credit institutions.	EFSF Regulation
COMPETITION ISSUES OUTSIDE CRA REGULATION			
	A network of European small and medium size rating agencies	A network of European small and medium size rating agencies would be promoted under a European Programme. This could consist of the future Competitiveness and SME programme to be established (as successor of the CIP programme) by the Enterprise and Industry Directorate General or by the "Horizon 2020" programme for innovation related actions managed by DG Research; in both cases, the financing would be possible as of 2014 at the earliest. This network would enable participating small and medium rating agencies to share data, best practice on rating methodologies and resources.	The common strategic framework for research and innovation funding (Horizon 2020) or the new Competitiveness and SME programme for the continuation of the non-innovative actions of the CIP

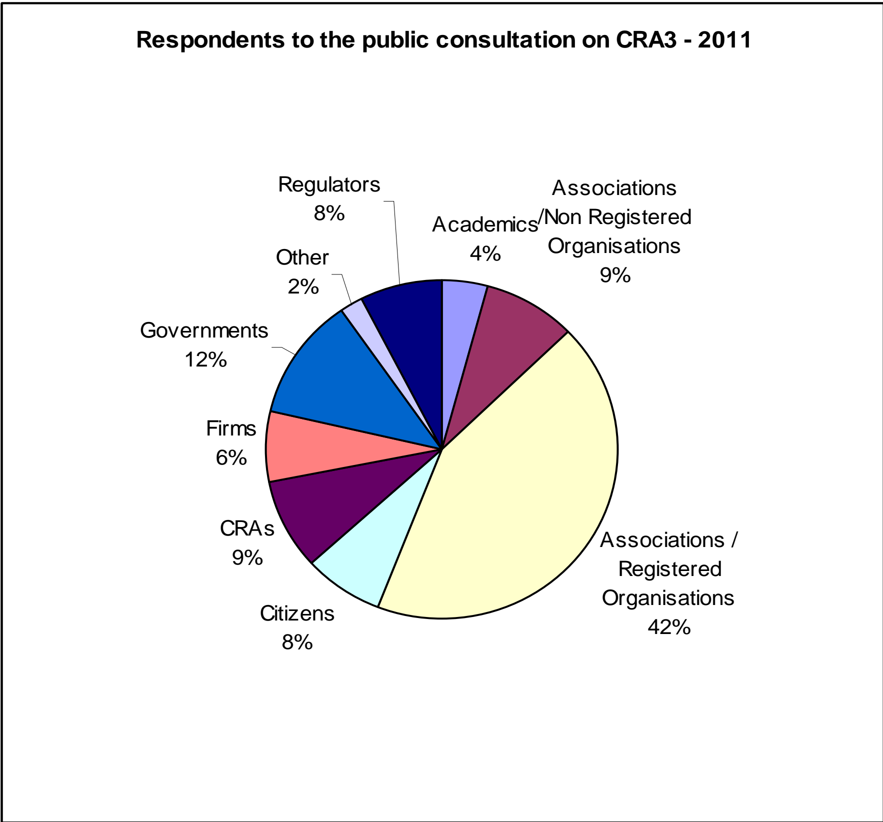
Annex II. Stakeholder Consultation

1 – Summary of Responses to the Public Consultation Paper on new initiatives of CRAs

The purpose of this annex is to summarise the responses to the Public Consultation on Credit Rating Agencies launched by the European Commission services on 5 November 2010 and closed on 7 January 2011. The consultation attracted approximately 100 responses from a range of respondents including Member States' competent authorities, academics, firms, citizens, registered and non-registered associations in addition to CRAs themselves.

The non-confidential responses to the consultation are published on the EU Commission's website: http://ec.europa.eu/internal_market/consultations/2010/cra_en.htm.

The chart below shows the distribution of the approximately 100 respondents among different categories:



1. OVERRELIANCE ON EXTERNAL CREDIT RATINGS

1.1 Reference to external ratings in regulatory capital frameworks for credit institutions, investment firms, insurance and reinsurance undertakings

Many responses echoed concerns about overreliance on ratings, and although there is support for reducing references to ratings in legislation gradually, so as to avoid a shock, even from some CRAs as well as some regulators. Respondents including regulators noted that part of the challenge will lie in finding suitable measures to replace them. Using market measures instead of ratings was seen as inappropriately pro-cyclical and volatile by many including industry groups and governments, but at the same time they could be taken into account

alongside other measures and or good quality ratings according to national regulators, governments, banks and industry groups. Respondents including banks also felt that good quality ratings were helpful and should continue to be used, but that it was important to incentivise the development of internal ratings abilities for firms with sufficient resources. There was concern from respondents such as investor groups and governments about firms investing in instruments whose credit risk was difficult to assess independently, although several respondents, especially industry representatives felt that this was sufficiently addressed in CRD II. However respondents noted that risk is necessary in the financial markets and that external ratings alongside internal ratings models could continue to be used so long as they were of reliable quality. There was opposition to the idea of requiring multiple ratings from most sectors of respondents, including banks, governments, industry associations.

Many responses drew the attention to ongoing work in Basel (in particular on the capital framework for securitisations) and suggested waiting for the outcome of this work.

1.2 Use of external ratings for internal risk management purposes

There was widespread support for a requirement for firms to conduct their own due diligence without relying exclusively on ratings from respondents in several categories, including industry associations, governments and regulators and rating agencies. However, there was a small amount of concern regarding smaller firms' abilities to perform such analysis. It was mentioned that current sectoral legislation already contains such requirements which have recently been strengthened. A range of different stakeholders, among them governments, industry associations and regulators, offered support for increased transparency including disclosure of firms' reliance on external ratings. There was also strong support for all information used by CRAs for rating structured finance instruments to be made available to everyone while some expressed concern about the costs of such a measure, confidentiality issues and international consistency. While there were mixed views on whether or not sovereign debt ratings were based on publically available information – some felt that private meetings were also involved, or that even if based on public information, CRAs added value, not all respondents thought this meant that all firms would have the capacity to analyse this information similarly.

1.3 Use of external ratings in the mandates and investment policies of investment managers

There was considerable support for avoiding mechanistic use of ratings, with some regulators, governments and several industry associations supporting a 'flexibility clause', while other respondents from the same groups did not support such a clause. However, industry associations, several governments and regulators CRAs were mostly cautious regarding the introduction of specific legislation to mandate flexibility and proportions of portfolios dependent on ratings, with support for market-led approaches and for investment managers to rely on their judgment. There was again caution from some governments, CRAs and industry groups against relying on market data to measure credit risk, though few proposals for alternatives to external ratings. On the other hand, some of the same stakeholder groups proposed that cautiously, and for the right assets only, market measures could be used.

2. SOVEREIGN DEBT RATINGS

2.1 Enhance transparency and monitoring of sovereign debt ratings

There was a general consensus that sovereign issuers should not receive fundamentally different treatment to corporate issuers. There were calls from some governments and industry stakeholders for increased transparency regarding methodologies and publication of the full research reports underlying ratings, although a small number in this group opposed this idea. Some governments wished to propose a maximum period of time for the review of sovereign ratings. On the other hand, many respondents, across all stakeholder groups, including some rating agencies, was that sovereigns should not be treated significantly differently from other issuers, albeit a few stating that CRAs should be more alert to changes in all cases. The 3 days' notice measure, while supported by some Member States and regulators, caused to some others Member States and regulators concern, in particular because of risks of market abuse and conflict of interest issues.

2.2 Enhanced requirements on the methodology and the process of rating sovereign debt

In terms of ratings methodologies, there was strong support from various kinds of respondents for an improved transparency, and further calls to treat sovereign issuers in a similar way to corporate issuers. There was some support including from some regulators for postponing publication until close of business, but on the other hand, many respondents, including other regulators and Member States' considered this less effective when trading continues around the globe. Fewer respondents approached the issue of Member States not paying for ratings, with no real discernible trends of groups in favour or against: some felt that this would not reduce conflicts of interest, while others supported the measures and asked for a common European approach.

3. ENHANCING COMPETITION IN THE CREDIT RATING INDUSTRY

Overall, there was general concern about the lack of competition in the credit rating industry, but caution against interventions in this commercial market, with importance placed on maintaining a level playing field. On the other hand there were some propositions for increasing competition, such as driving demand by requiring more ratings by a greater number of agencies, encouraging specialists, but there was similarly some representation against specific legislation in this area.

3.1 European Central Bank or National Central Banks

There was opposition among a wide range of stakeholders for the ECB or National Central Banks to establish ratings. The ECB itself appears to oppose to the idea to publicly issue ratings for reasons of independence. Governments and regulators, while some were supportive to this idea; others were sceptical of public sector involvement in the ratings sphere.

3.2 New National Entrants

A limited number of stakeholders responded in this area. Some governments, finance industry groups said that if such an option would be pursued, operational independence would be a key factor. On the other hands, some other governments, finance industry groups and CRAs were against state intervention to stimulate new entrants.

3.3 Public/Private structures

Some Member States proposed the idea of Public/private structures to be further considered and analysed. At the same time, some of these respondents further noted the problems of credibility and conflicts of interest that could be caused by direct funding arrangements and which would need to be addressed. Some national regulators and several private enterprises opposed the creation of a new European CRA.

3.4 European Network of Small and Medium-sized Credit Rating Agencies

There was some support from a group of Small and Medium-sized CRAS for the idea of a European Network of Small and Medium-sized Rating Agencies. However, some regulators, and governments felt this would not be effective.

4. CIVIL LIABILITY OF CREDIT RATING AGENCIES

Several respondents from various stakeholder groups encompassing some governments, regulators and banking industry bodies supported the possibility of civil liability claims against CRAs, but only for gross negligence or intent. Several respondents including respondents from all stakeholder groups expressed concerns about respecting existing legal systems, and the difficulty in establishing and disruption that caused by simply applying a common standard across all of them. Taking responses as a whole to this section, there seemed to be general support (with the notable exception of the CRAs themselves, arguing that this would, for instance, increase reliance) for the notion that it should be possible to pursue civil action, in the case of both solicited and unsolicited ratings, but that this should be reserved for severe cases only, not simply where investors suffer loss. Other measures proposed included increased regulatory scrutiny and punishment of offenders. There was very little support for introducing the concept of an 'incorrect' rating. .

5. POTENTIAL CONFLICTS OF INTEREST DUE TO THE "ISSUER-PAYS" MODEL

Respondents agreed that the "issuer-pays" model inherently contains conflicts of interest, although respondents of all kinds also stated that it should be possible to manage and minimise these conflicts, and in addition, other models were also conflicted.

5.1. "Subscriber/Investor-Pays" model

Some financial firms and their industry bodies felt that increasing the cost of investment risked reducing demand for securities. Further respondents including competent authorities and governments noted that this model could reduce the independence of CRAs.

5.2. "Payment-upon-results" model

Some national authorities, government and trade bodies of financial firms were opposed to this idea and expressed scepticism as to the feasibility of implementing such a system. One trade body and one national authority were concerned that this model could lead to the erroneous notion of "right" or "wrong" ratings.

5.3. "Trading venues Pay" model

There was some support from the academic sphere for this model. However, among market participants, public authorities and interested third parties, this model was not a favoured

option, especially in view of the large number of unlisted securities which would not be covered.

5.4. Government as Hiring Agent model

Governments responding to this question felt that this model had negative implications for conflicts of interest. There were also concerns about cost and how the model could be operated.

5.5. Public Utility model

The trade bodies and public authorities responding to this option were concerned at the expense of such an option, and some of these had concerns about increasing overreliance and regarding conflicts of interest, particularly rating of sovereign debt during a crisis.

General outcome

Overall, throughout the responses to the consultation, there were occasional calls for the Commission to wait for the full effect of CRA I and CRA II to become known, and some respondents called for the work of the G20 and Basel to be taken into account.

2 – Roundtable on Credit Rating Agencies

6 July 2011, Berlaymont Building, Rue de la Loi 200 – 1049 Brussels

Summary of points raised in the roundtable

The purpose of the roundtable was to gather views from various shareholders in order to shape future policy in the field of credit rating agencies (hereafter referred to as CRAs) complementing existing EU regulation. The roundtable was chaired by Deputy Director General of the Directorate General for Internal Market and Services, Mrs Nadia Calviño. Conclusions were drawn by Maria Velentza, Head of Unit of "Financial Stability" of the same Directorate General. It was attended by approximately 60 participants, representing all relevant stakeholder groups (European institutions and agencies, Member States, rating agencies, issuers, including various industry federations and representatives of the financial services industry, academia etc).

We have not attributed particular statements to individuals present, but have tried to represent the views expressed by various stakeholder groups. The following is only intended as a summary of the discussion that occurred on this day, and does not try to represent the official lines taken by particular industry representatives, bodies or Member States.

Overreliance on CRAs

Issues debated:

- What alternative measures of credit risk could be used instead of external credit ratings? Does the answer differ across asset classes: corporate, financial, sovereign, structured finance?
- Should alternative measures of credit risk, including internal models and enhanced risk management, be used in isolation or in combination with external ratings?
- How do you assess transparency and data availability in structured finance? Is there enough transparency to allow financial firms to assess the credit risks of structured finance instruments themselves?

In this section of the discussion, participants were unanimous on the importance of reducing overreliance on ratings, particularly mechanistic reliance. Although there was consensus that action should be taken, some participants cautioned against overreacting in the wake of the crisis.

A number of participants said that market players including investors did not perform enough of their own due diligence and risk analysis or did not have sufficient understanding of ratings,.

In order to facilitate improved due diligence and credit risk assessment, many proposed greater transparency and access to information. However, some warned that simply providing more information would not lead to greater understanding and less overreliance, stressing the need to incentivise market participants' own due diligence, including in the area of product innovation.

Some participants raised the issue of intellectual property in relation to transparency, though not all agreed this was an issue.

A large number of participants said that references to ratings in legislation were important in driving overreliance and that they should be removed, though some called for this to be done gradually. However, the general consensus was that removing references to ratings in legislation is just one step and is not an immediate cure.

Some cautioned that a move to internal ratings could take time in order to first ensure quality or because such ratings would also be subject to conflicts and quality issues. Some of these participants mentioned that in particular some SMEs do not currently have the capacity to perform their own ratings and process large amounts of information.

Participants acknowledged the difficulty in finding suitable alternatives to ratings in legislation. A few participants drew a link between overreliance and competition. In addition, the presence of ratings in private contracts, particularly in the asset management sector was raised, although this falls outside of the remit of EU legislation.

A number of participants raised the importance of supervision and enforcement to ensure appropriate use of and to prevent overreliance on ratings.

Sovereign debt ratings

Issues debated:

- Do you agree that the specificities of sovereign debt ratings justify enhanced requirements for sovereign debt ratings compared to other rating classes? If this is the case, what kind of requirements would you suggest?
- How can the transparency and monitoring of sovereign debt ratings be improved?
- How can investors' understanding of sovereign debt rating actions be enhanced?

Many participants expressed serious concerns with some sovereign ratings issued by large CRAs. Some referred to concrete examples of recent European downgrades that they found inexplicable since some CRAs appeared to fail to take account or assess in a consistent manner all relevant information, such as support initiatives and other factors, when issuing ratings. Others did not understand why major rating changes were made when no new information was available. Participants said that some ratings issued by CRAs were 'not logical', 'questionable' 'disruptive' and 'not credible'.

Some participants countered that some inaccurate statements were made, and that ratings are imperfect due to their forward-looking nature, adding further that methodologies were publicly available.

There was no consensus as to whether sovereign ratings should be subject to a specific regulation. Some participants felt that sovereign rating should be distinguished from other rating classes, whereas others felt that it should not be treated differently.

Some said it was important to take into account spillover effects and that in general, more understanding of sovereign ratings was needed.

One participant said that not only references to ratings in legislation, but risk weightings for sovereign debt had encouraged a cycle of irresponsible borrowing, but also irresponsible lending. A few participants considered possible to set up a European body to rate sovereign debt, though others were against, stressing the importance of maintaining a level playing field.

There were several calls for increased transparency. There was general consensus on publication of full reports and explanation and justification behind sovereign rating changes, and also detail on the staff involved and time devoted to the rating.

There was opposition to the possible measure included in the consultation to requests 3 days' notice to be given for sovereign rating changes, mainly because of market abuse risks. However, some called for notice to be given with sufficient working hours to respond, rather than the current 12 hour requirement.

Some said it was important to increase competition to increase the number of opinions in the market. One participant suggested distinguish between issuer pays and investor pays models when drafting rules, as an advanced notice rule would not be suitable for an investor solicited rating.

Enhancing competition in the CRA industry

Issues debated:

- How can new players be encouraged to enter the credit rating agency sector?
- What are your views about creating a network of CRAs? Do you consider that such a network could help increase competition in the credit rating agency sector?
- What are your views about creating a new independent European Credit Rating Agency?

Many participants expressed concern at the oligopolistic structure of the credit rating market, despite the existence of strong regional or specialist players, and stressed the need to increase competition and to encourage more players in the market. One cited a past example of large corporations downgraded by some rating agencies, whereas other agencies maintained investment grade ratings, allowing the corporations to continue to raise funding and to continue to be profitable today. Some noted the importance of local knowledge in this respect.

A few participants said that more players would not necessarily improve competition or that more competition could be stimulated within the current structure. One participant thought that more competition could worsen the quality of ratings, though this was contested by other participants.

A representative of the European Parliament explained the proposals regarding the creation of a publicly supported new European rating agency in the form of a foundation for which the European Parliament requested the Commission to conduct an in-depth assessment.

The majority of participants were against a European rating agency as a public initiative, regardless of how it was funded. Some cited the long timeframe of around 10 years it might take for such an institution to gain credibility, while others thought it never would due to the questions about its independence and absence of conflicts of interest. Some felt that one new, large player would not increase competition. Others felt it was not appropriate to give public support to one specific agency or project over the rest, as this would distort competition.

A number of participants called for regulation to reduce and not increase barriers to entry. One participant noted that despite private ownership, CRAs have an important public responsibility and should base their actions on the public good. One proposed stimulating more competition by promoting comparability of the performance of ratings issued by CRAs.

Conflicts of interest in the issuer pays model

Issues debated:

- What are your views about the model currently discussed in the US (selection of the CRA by an independent board)?

- What are your views with respect to a regular rotation between CRAs in order to mitigate conflicts of interests due to the issuer-pays model?

Some participants noted that no model is free of conflicts of interest. One proposed the creation of a private not for profit investor-pays model foundation, suggesting that by having several stakeholders with different interests, conflicts could be minimised. Several participants called for more focus on conflicts in the registration process.

Some participants called for greater transparency to counter conflicts.

A few participants drew comparisons to the audit industry, with some advocating mandatory rotation. However others cautioned against this. A few participants cautioned against conflicts created by the shareholding structure of the largest CRAs, and the similarity between their shareholders.

One said that the issuer pays model had allowed issuers to bribe for favourable ratings, but this statement was strongly rejected by others.

Civil liability of CRAs

Issues debated:

- Do you think that credit rating agencies should be held liable if they infringe negligently or intentionally the CRA Regulation, thereby causing damage to investors?
- Do you see benefit in introducing a civil liability regime for CRAs in the CRA Regulation or should national legal orders provide for such a regime?

Some supported more stringent liability for CRAs, a few drawing parallels to the audit industry. A standard of gross negligence or intent was suggested. The opinion was also expressed that it would be easier to pursue liability claims against CRAs by moving to an investor-pays based model.

There were calls in various parts of the discussion by participants for CRAs to take responsibility for their actions, especially in view of the serious potential consequences. Some noted that CRAs can be sued, and that they sometimes are.

ANNEX III. INTERNATIONAL CONTEXT

This annex contains information regarding international legislation and policy initiatives in the field of CRAs.

1 – Overview

At the international level, the International Monetary Fund released (October, 2010) a global financial stability report with a specific focus on sovereign debt ratings.[138] The Financial Stability Board (FSB) has endorsed (October, 2010) principles[139] to reduce authorities' and financial institutions' reliance on CRA ratings and the G20 already approved the FSB's principles on reducing reliance on external credit ratings.[140]

The FSB principles cover five types of financial market activity: prudential supervision of banks; policies of investment managers and institutional investors; central bank operations; private sector margin requirements; and disclosure requirements for issuers of securities. The goal of the principles is to reduce the "cliff" effects from CRA ratings that can amplify procyclicality and cause systemic disruption. The principles call on authorities to do this through:

- Removing or replacing references to CRA ratings in laws and regulations, wherever possible, with suitable alternative standards of creditworthiness assessment;

- Expecting that banks, market participants and institutional investors make their own credit assessments, and not rely solely or mechanistically on CRA ratings.

The FSB has asked standard setters and regulators to consider next steps that could be taken to translate the principles into policy approaches tailored to specific financial sectors and market participants.

The Basel Committee on banking supervision is currently working on specific policy actions to reduce reliance on ratings in the regulatory framework. The Toronto G20 statement on 26-27 June 2010[141] called on the FSB to reduce the reliance on credit rating agency (CRA) ratings, and on the Basel Committee to address adverse incentives arising from the use of CRA ratings in the regulatory capital framework. In response to this request, the Committee established a working group (the Ratings and Securitisation working group) to review the Basel framework's reliance on ratings and made several recommendations to the Basel Committee, most of which were ultimately included in the Basel III rules text.[142]

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138 International Monetary Fund, World Economic and Financial Surveys Global Financial Stability Report, October 2010. Available from: http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf.

139 FSB, principles for reducing reliance on CRA ratings, adopted on 27 October 2010. Available from: http://www.financialstabilityboard.org/publications/r_101027.pdf.

140 G20 Seoul Summit leaders' Declaration, 11-12 November 2010. Available from: http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf.

141 G20, Toronto G20 summit declaration, 26-27 June 2010. Available from: http://www.g20.org/Documents/g20_declaration_en.pdf.

142 These included, for example, proposals to remove or reduce certain cliff effects related to ratings from the internal-ratings based (IRB) approach and standardised approach (SA). In particular, the RS group is now working on addressing adverse incentives and cliff effects arising from the use of CRA ratings through: (i) the recalibration of the risk weights for securitisation exposures under the ratings-based approach, including to reduce 'cliff effects'; (ii) the review of the hierarchy of approaches in the Securitisation framework with the aim of reducing the predominant role played by external ratings; and,

In parallel, the USA has also introduced more rigorous requirements on credit rating agencies. The adopted Dodd-Frank Wall Street Reform and Consumer Protection Act [143] which strengthens provisions on accountability and transparency of credit rating agencies to rate structured finance instruments[144], including rules on corporate governance, presentation of ratings, methodologies. In addition, Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires federal agencies to review how existing regulations rely on credit ratings and remove such references from their rules as appropriate. The Securities and Exchange Commission[145] (SEC) is currently exploring ways to reduce regulatory reliance on external credit ratings and replace them with alternative criteria. For instance, SEC proposed amendments to its rules that would remove credit ratings as one of the conditions for companies seeking to use short-form registration when registering securities for public sale. One of the criteria that allowed US issuers to use this registration for their public offerings was that the securities to be offered had to be rated investment grade by at least one NRSRO.[146]

2 – Summary of FSB Report on overreliance to external credit ratings

On 14th of October 2010, FSB has released a report to G20 Finance Ministers and Governors on reducing reliance on CRA ratings.[147]

The principles have been developed by the FSB, in consultation with international standard setters:

I. Reducing reliance on CRA ratings in standards, laws and regulations

Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.

II. Reducing market reliance on CRA ratings

Banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA ratings.

III.1. Central bank operations

Central banks should reach their own credit judgements on the financial instruments that they will accept in market operations, both as collateral and as outright purchases. Central bank policies should avoid mechanistic approaches that could lead to unnecessarily abrupt and large changes in the eligibility of financial instruments and the level of haircuts that may exacerbate "cliff" effects.

III.2. Prudential supervision of banks

Banks must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This implies that banks should have the capability to conduct their own assessment of

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(iii) the enhancement of internal assessment and due diligence requirements. Final proposals on these topics are expected to be completed in time for the September 2011 meeting of the Basel Committee.

143 Dodd-Frank Wall Street Reform and Consumer Protection Act, 29 June, 2010.

144 Ibid, Sec. 932.

145 SEC Initiatives under New Regulatory Reform Law.

146 SEC Proposes First in Series of Rule Amendments to Remove References to Credit Ratings, 9 February 2011. Available from: http://www.sec.gov/rules/proposed/2011/33-9186.pdf.

147 FSB Report on Principles for Reducing Reliance on CRA Ratings, 27/10/2010. Available from: http://www.financialstabilityboard.org/publications/r_101027.pdf.

the creditworthiness of, as well as other risks relating to, the financial instruments they are exposed to and should satisfy supervisors of that capability.

III.2.a. Larger, more sophisticated banks within each jurisdiction should be expected to assess the credit risk of everything they hold (either outright or as collateral), whether it is for investment or for trading purposes.

III.2.b. Smaller, less sophisticated banks may not have the resources to conduct internal credit assessments for all their investments, but still should not mechanistically rely on CRA ratings and should publicly disclose their credit assessment approach.

III.3. Internal limits and investment policies of investment managers and institutional investors

III.3.a. Investment managers should conduct risk analysis commensurate with the complexity and other characteristics of the investment and the materiality of their exposure, or refrain from such investments. They should publicly disclose information about their risk management approach, including their credit assessment processes.

III.3.b. Senior management and boards of institutional investors have a responsibility to ensure that internal assessments of credit and other risks associated with their investments are being made, and that the investment managers they use have the skills to understand the instruments that they are investing in and exposures they face, and do not mechanistically rely on CRA ratings. Senior management, boards and trustees should ensure adequate public disclosure of how CRA ratings are used in risk assessment processes.

III.3.c Regulatory regimes should incentivise investment managers and institutional investors to avoid mechanistic use of CRA ratings.

III.4. Private sector margin agreements

Market participants and central counterparties should not use changes in CRA ratings of counterparties or of collateral assets as automatic triggers for large, discrete collateral calls in margin agreements on derivatives and securities financing transactions.

III.4.a. Supervisors should review the margining policies of market participants and central counterparties to guard against undue reliance on CRA ratings.

III.5. Disclosures by issuers of securities

Issuers of securities should disclose comprehensive, timely information that will enable investors to make their own independent investment judgements and credit risk assessments of those securities. In the case of publicly-traded securities, this should be a public disclosure.

III.5.a. Standard setters and authorities should review whether any references to CRA ratings in standards, laws and regulations relating to disclosure requirements are providing unintended incentives for investors to rely excessively on CRA ratings and, if appropriate, remove or amend these requirements.

Next steps

Standard setters and regulators should incentivise a transition to a reduced reliance on CRA ratings over a reasonable timeframe extending into the medium term. It should take into account the need for market participants to build up their own risk management capabilities to replace reliance on CRA ratings. The milestones should be clearly visible.

3 – Basel Committee on Banking Supervision

Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year.

The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its 12 member permanent Secretariat is located. The Committee is often referred to as the BIS Committee after its meeting location. However, the BIS and the Basel Committee remain two distinct entities.[148]

The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision (see bank regulation or Basel II Accord, for example) in the expectation that member authorities and other nations' authorities will take steps to implement them through their own national systems, whether in statutory form or otherwise.

The purpose of the committee is to encourage convergence toward common approaches and standards. Dieter Kerwer reports that "the BCBS is not a classical multilateral organization. It has no founding treaty, and it does not issue binding regulation. Rather, its main function is to act as an informal forum to find policy solutions and to promulgate standards."[149]

At present the IMF is collaborating with the Committee to improve bank regulation.

The Basel committee along with its sister organizations, the International Organization of Securities Commissions and International Association of Insurance Supervisors together make up the Joint Forum of international financial regulators.

Basel II

Basel II is an international initiative that requires financial services companies to have a more risk sensitive framework for the assessment of regulatory capital.

The Basel Capital Accord sets international capital adequacy standards. In 1988, the Basel Committee on Banking Supervision established a method of relating capital assets, using a simple system of risk weights and a minimum capital ratio of 8%.

The planned implementation date for Basel II is December 2006 with parallel running from January 2006. Banks, academics and politicians, particularly in the USA are demanding changes to the draft rules, which they believe are too complex, overly prescriptive and costly. These changes may in turn cause delays to the implementation of the final Accord.

Basel II is based on the concept of 3 Pillars:

1. Minimum capital requirements

2. Supervisory Committee

3. Market Discipline

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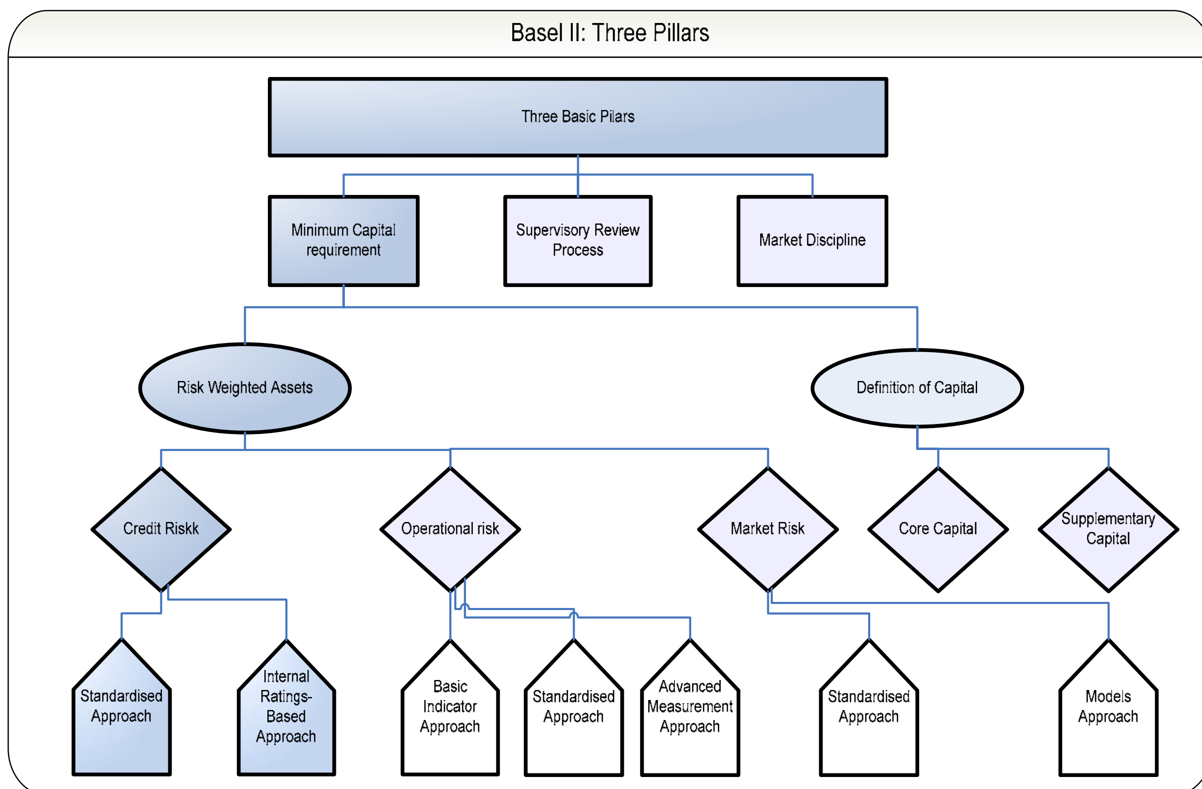
148 Marrison, Chris (2002). The Fundamentals of Risk Measurement. New York, New York: McGraw Hill. pp. 340–342.

149 Kerwer, Dieter (October 2005). "Rules that many use: standards and global regulation". Governance 18 (4): 611–632.



Basel II not only affects traditional finance companies, but they also influence other areas such as the cost of project finance for Infrastructure Projects.

Basel III

The Toronto G20 statement on 26-27 June 2010 called on the FSB to reduce the reliance on credit rating agency (CRA) ratings, and on the Basel Committee to address adverse incentives arising from the use of CRA ratings in the regulatory capital framework.

In response to this request, the Committee established a working group (the Ratings and Securitisation working group) to review the Basel framework's reliance on ratings and made several recommendations to the Basel Committee, most of which were ultimately included in the Basel III rules text.

Basel III work on ratings and securitisation is planned to be finalised by the end of 2011.

4 – IOSCO disclosure principles for public offerings and listings of asset-backed securities

In April 2010, the International Organisation of Securities Commissions (IOSCO) published its Final Report on Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities. [150] IOSCO had previously decided that its previously published disclosure requirements did not fully capture all the information needed by ABS investors. The principles are designed to be taken into account by securities regulators in the scope of their disclosure requirement regimes. The principles were developed within the remit of IOSCO's work following its 2008 Final Report on the Subprime Crisis. [151] Poor disclosure and poor investor understanding and oversight of underlying assets in ABS were significant

[150] The full report can be viewed at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD318.pdf and a summary of the main points at: http://www.iosco.org/news/pdf/IOSCONEWS180.pdf.

[151] The full report can be viewed at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf.

contributing factors to the Crisis. The main areas of disclosure proposed by IOSCO for ABS are as follows:

1. Parties Responsible for the Document;

2. Identity of Parties Involved In the Transaction;

3. Functions and Responsibilities of Significant Parties Involved In the Securitization Transaction;

4. Static Pool Information;

5. Pool Assets;

6. Significant Obligors of Pool Assets;

7. Description of the Asset Backed Securities;

8. Structure of the Transaction;

9. Credit Enhancement and Other Support, Excluding Certain Derivative Instruments;

10. Certain Derivative Instruments;

11. Risk Factors;

12. Markets;

13. Information about the Public Offering;

14. Taxation;

15. Legal Proceedings;

16. Reports;

17. Affiliations and Certain Relationships and Related Transactions;

18. Interests of Experts and Counsel; and

19. Additional Information.

The guidance does not cover ABS where the asset pool is actively managed by the issuer.

In the EU, the Prospectus Directive contains an Annex regarding the issuance of ABS.

5 – Comparison of the existing regulatory frameworks for CRAs in EU and US

Registration, supervision, enforcement power		
Requirement	**EU**	**US**
Mandatory registration	This is required. Activity of unregistered CRAs and use of their ratings for regulatory purposes is prohibited. (Art. 4(1), 14).	Not at this stage. However, the ratings of a non-registered CRA cannot be used for regulatory purposes. The scope of use of credit ratings for regulatory purposes is much broader than in the EU therefore there is a big incentive to acquire NRSRO status. A proposal to amend the registration requirements is included in the Wall Street Reform and Consumer protection act of 2009.

Legal / physical presence requirement	As a rule, CRAs need to be legal persons established in the EU. There is a specific regime for certified CRAs, which may be exempt from the requirement of physical presence. Endorsement of ratings produced by overseas CRAs is possible. (Art. 4, 5, 14(1)).	No. CRAs to promptly furnish the SEC with legible, complete, and current copies, and, if specifically requested, English translations of records.
Supervision by a public authority	As of March 2010 competent authorities of the Member States with CESR co-ordination. (Art. 22). ESMA now supervises CRAs: they must register with ESMA which has supervisory powers including information requests, access to personnel and inspection powers and the CRAs must pay fees in respect of this supervision.	The SEC has statutory authority to oversee CRAs (NRSROs) as of 2007.
Supervisory authority empowered to impose sanctions	Yes. (Art. 36).	Yes.
Organisational, corporate requirements		
Requirement	**EU**	**US**
Rating policy review function	There is a requirement for an internal function to review the methodologies, models and significant changes to methodologies and models. This function should be independent of the business lines and report to the independent members of the board. (Annex I.A.9).	Not envisaged. Bill of Restoring American Financial Stability Act proposed by Senate in March 2010 proposes that SEC would be directed to issue rules under which registered CRAs have to adopt procedures for the development and oversight of rating methodologies. Under Dodd-Frank, NRSROs are required to establish and maintain internal controls over methodologies, and produce a report on this.
Compliance function	A permanent and effective compliance function operating independently of the business lines is required. This function must report regularly to senior management and the independent members of the board. (Annex I.A.5-6).	A registered CRA should designate a compliance officer.
Independent members of the administrative or supervisory board	At least 1/3 but not less than 2 independent members required. They have the specific task of monitoring the development of the rating policy and	Not envisaged, but a designated compliance officer is responsible for specific monitoring tasks that the EU Regulation attributes to independent

	methodologies, effectiveness of the rating internal quality systems, effectiveness of procedures dealing with conflicts of interest, compliance and governance processes. (Annex I.A.2).	members. Wall Street Reform Act of 2009 proposes to introduce requirements for independent directors with specific monitoring tasks.

Conflicts of interest

Requirement	EU	US
General policy	CRAs are to ensure that conflicts of interest will not affect ratings. Actual or potential conflicts of interest to be (i) identified and either (ii.1) eliminated or (ii.2) properly managed and in any case disclosed. Some conflicts of interest are prohibited by law. (Annex I.B.1).	Conflicts of interest to be (i) identified and either (ii.1) eliminated or (ii.2) properly managed and disclosed. Some conflicts of interest prohibited by law.
Prohibited conflicts of interest	Ratings not to be issued and existing, potentially compromised ratings are to be immediately flagged as such when: 1) CRA, an analyst or person approving ratings has direct or indirect ownership in the rated entity (collective investment schemes excluded); 2) the rated entity is linked by control to CRA; 3) an analyst or person approving ratings is a member of supervisory or management board of the rated entity; 4) an analyst, or person approving the ratings has had a relationship with the rated entity, that may produce conflicts of interest. (Annex I.B.3)	A CRA is prohibited from having the following conflicts of interest, where it issues or maintains a rating: 1) CRA receives 10% or more of its net revenue from one entity; 2) analyst or person approving ratings has securities or any other direct ownership in the rated entity (sovereign issuers excluded); 3) analyst or person approving ratings is an officer or director of the rated entity; 4) CRA associated with the rated entity; 5) CRA has provided recommendations on the legal structure, assets, liabilities or activities of the issuer of the securities; 6) analyst or person approving the rating or person developing methodologies for determining ratings has negotiated fees with the rated entity;

		7) analyst or person approving the rating receives gifts valued at above 25$ in total. In addition specific unfair coercive or abusive practices are prohibited (e.g. conditioning the issuance of rating on the purchase of another service by the CRA).
Provision of consulting/advisory services	It is prohibited to provide consulting or advisory services to the rated entity or its related third party. (Annex I.B.4).	Not prohibited but conflict of interest has to be disclosed and properly managed. 'Wall Street reform act proposes to include advisory services among prohibited activities.
Provision of ancillary services	Only specific ancillary services may be provided (market forecasts, estimates of economic trends, pricing analysis and other general data analysis as well as related distribution services). The CRA is to ensure that ancillary services do not present a conflict of interest with the rating activity and to disclose in the final rating any ancillary services provided to the rated entity. (Annex I.B.4).	Provision of ancillary services to the rated entities is qualified as a potential conflict of interest. CRAs are required to disclose in form NRSRO the types of ancillary services they provide. The SEC may verify if potential or actual conflicts of interest in this area are properly addressed.
Rating staff		
Requirement	**EU**	**US**
Compensation and performance evaluation of analysts	Compensation and performance evaluation of analysts is not to be contingent on the amount of revenue generated. (Art. 7(5)).	Not envisaged but covered by general provision to disclose and manage conflicts of interest.
Rating staff engagement in fee negotiations	Prohibited. (Art. 7(2)).	Prohibited (included among prohibited conflicts of interest).
Rules on conduct of the staff engaged in the rating process	- It is prohibited for the rating analysts and person approving the ratings to engage in any transactions in instruments related to the rated entity; - It is prohibited to accept money, gifts or favours from anyone the CRA does business with; - Handling confidential information	The following are not allowed as a prohibited conflict of interest: 2) analyst or person approving ratings has securities or any other direct ownership in the rated entity (sovereign issuers excluded); 7) analyst or person approving the rating receives gifts valued at above 25$ in total;

	(incl. unpublished ratings); - Look-back reviews of ratings when an analyst has left the CRA to work for an entity it rates. (Annex I.C.1, 3, 4, 6)	- CRAs expected to establish and enforce written policies and procedures to prevent the misuse of material non-public information; - Look back reviews envisaged under the Wall Street Reform act in case an employee of rated entity was employed by CRA and participated in rating activity for that entity, and there are disclosure requirements.
Rules excluding employees from the rating process	Rating analysts and persons approving ratings are prohibited from being engaged in rating an entity where there are conflicts of interest arising from owning financial instruments, recent employment, business or other relationships. (Annex I.C.2)	The following are not allowed as a prohibited conflict of interest: 2) analyst or person approving ratings has securities or any other direct ownership in the rated entity (sovereign issuers excluded); 3) analyst or person approving ratings is an officer or director of the rated entity; 7) analyst or person approving the rating receives gifts valued at above 25$ in total.
Rotation	Rotation of rating staff is mandatory: - lead rating analyst – not to provide services to a client for more than 4 years; - other rating analysts – not to provide services to a client for more than 5 years; - persons approving the ratings – not to provide services to a client for more than 7 years. (Art. 7(4), Annex I.C.7).	Not envisaged. However, there is a general rule to prevent, disclose and or manage conflicts of interest. The procedure for managing conflicts of interest may include rotation mechanism. The Wall Street Reform Act proposes to direct SEC to undertake a study on a possible mandatory rotation mechanism.
Quality of ratings		
Requirement	**EU**	**US**
CRAs' independence in determining their methodologies and the content of their	Ensured. Public authorities are not to interfere in the methodologies and content of ratings. (Art. 23(1)).	Ensured. SEC and state authorities prohibited from regulating the substance of credit ratings or the procedures and methodologies for developing them.

ratings		NRSROs will be required to ensure that methodologies used for ratings are approved by the Board (Section 15(E)(r)(1).
Monitoring activity:	Monitoring of ratings required on an on-going basis (as well as at least an annual review). (Art. 8(5)).	CRAs are required to disclose procedures for monitoring, reviewing and updating the ratings including how frequently ratings are reviewed. NRSRO Boards required under Dodd-Frank to ensure that the internal control system, including with respect to policies and procedures for determining credit ratings. (Section 15(E)(t)(3).
Impact of methodology changes on existing ratings	When a methodology, model or key rating assumption is changed, a CRA is expected to: (a) immediately, using the same means of communication as used for the distribution of the affected credit ratings, disclose the likely scope of credit ratings to be affected; (b) review the affected credit ratings as soon as possible and no later than six months after the change, in the meantime placing those ratings under observation; and (c) re-rate all credit ratings that have been based on those methodologies, models or key rating assumptions if, following the review, the overall combined effect of the changes affects those credit ratings. (Art. 8(6)).	CRAs are required to disclose if changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings. New legislation (Wall Street Act, Restoring the Financial Stability act) contains proposal that material changes to methodology have to be applied in a consistent manner (CESR advice paragraph 627). NRSROs will be required to apply such changes to all relevant ratings within a reasonable time determined by the SEC (Section 15E(r)(2)(A) and (B). In line with this requirement, NRSROs will have to immediately disclose the likely scope of ratings affected by such changes to methodology by the same means as the ratings were distributed, including disclosure of errors that have been discovered.
Quality of data used	A CRA is expected state clearly and prominently when disclosing any credit rating whether it considers satisfactory the quality of information available on the rated entity and to	CRAs required to give a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party

	what extent it has verified information provided to it by the rated entity or its related third party. For structured finance instruments, a CRA is expected to state what level of assessment it has performed concerning the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments. (Annex I.D.I.4, I.D.II.2).	vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings. Wall Street Reform Act proposes to introduce requirement to disclose on a rating by rating basis information on the reliability, accuracy and quality of the data relied on in the determination of the rating (CESR advice para 650). Under Dodd-Frank, NRSROs will be required to assess the quality of the information relied on, and publish this information alongside any ratings issued (Section 15E(s). NRSROs will also be obliged to consider information from sources other than issuers and underwriters where this is credible (Section 15(E)(v). In addition, the SEC is required to adopt rules including requiring CRAs to publish a statement including the extent to which essential data was available (which may be especially relevant in unsolicited ratings) and limits on historical data.
Limits to rating activity	CRAs shall refrain from issuing a rating or withdraw an existing rating when there is a (i) lack of robust data; (ii) complexity of a structure of a new instrument; (iii) unsatisfactory quality of information or that serious questions as to whether a credible rating can be produced. (Annex I.D.I.4).	Not envisaged. (653).
Transparency and disclosures		
Requirement	**EU**	**US**
Disclosure of rating actions	If ratings are intended for distribution channels or for the public, any rating	A CRA is required to disclose credit ratings on the internet or through

	decision should be disclosed on a non-selective basis and in a timely manner. (also applicable to the subscriber-pays model) (Art. 10(1)).	other accessible means in order to meet the statutory definition of "credit rating agency" (736 ff).
Disclosure of full ratings history	Not envisaged.	From June 2010 CRAs must publicly disclose on their website the rating history information for all ratings determined by the CRA after June 2007 ("100% requirement") (795 ff).
Differentiation of structured finance ratings	When a CRA issues credit ratings for structured finance instruments, it shall ensure that rating categories that are attributed to structured finance instruments are clearly differentiated using an additional symbol which distinguishes them from rating categories used for any other entities, financial instruments or financial obligations. (Art. 10(3)).	Currently there is no differentiation required. This proposal has been deferred in Nov 2009. Now the SEC is investigating alternative measures to differentiate SF from other ratings, e.g. enhanced disclosure of information (see CESR advice 854 ff). Dodd-Frank provisions capture most structured finance ratings through a definition of 'asset backed securities', with required actions including use of symbols to differentiate structured finance ratings from others (Section 15E(s)(1)(B)), disclosure of assumptions and warnings on volatility of ratings (Section 15E(s)(3).
Disclosure of methodologies, models and key assumptions in use	CRAs are required to disclose on an on-going basis the methodologies, and descriptions of models and key rating assumptions such as mathematical or correlation assumptions used in its credit rating activities as well as their material changes. (Art. 8(1), Annex I.E.I.5). CRA must also indicate the principle methodology that was used in determining a specific rating (Annex I D I 2 b).	A general description is required of the procedures and methodologies used by the CRA to determine credit ratings, including unsolicited credit ratings within the classes of credit ratings for which the CRA is registered. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the CRA in determining credit ratings, including in particular descriptions of (…) the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction factor into the

		determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction. Further disclosure requirements on a rating by rating basis proposed in Wall Street Reform act (e.g. disclosure on the sensitivity of ratings to assumptions made by CRA, (733)).
Historical performance data (default and transition studies)	CRAs are to make available in a central repository established by CESR historical performance data including the ratings transition frequency and information about credit ratings issued in the past and on their changes. Data on the historical default rates of its rating categories to be provided every six months. A credit rating agency shall provide information to that repository on a standard form as provided for by CESR. CESR shall make that information accessible to the public and shall publish summary information on the main developments observed on an annual basis. (Art. 11(2), Annex I.E.II.1).	Envisaged as disclosure on website. (1, 3, 10 year horizon required for each rating category). Methods used for calculation to be publicly explained. (790). Proposed amendments under Wall Street Reform act will direct SEC to require each CRA to disclose information on the historical performance of each rating (799 ff).
Standards on presentation of rating reports	Envisaged. (Annex I.D.I).	Envisaged.
Record keeping obligations		
Requirement	**EU**	**US**
Internal records retention period	Internal records must be kept for at least 5 years (Annex I.A.8).	Internal records must be kept for 3 years.
Other issues		
Requirement	**EU**	**US**
Notching practice (discriminatory treatment of ratings issued by other CRAs in situations where they could be used in the CRA's	CRAs are prohibited to refuse to issue a rating of an entity or a financial instrument because a portion of the entity or the financial instrument had been previously rated by another CRA. All instances of downgrades of underlying assets or structured	The following is prohibited as anticompetitive behaviour: Issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to

rating process)	finance instruments shall be recorded and justified. (Art. 8(4)).	withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the CRA, where such practice is engaged in by the CRA for an anticompetitive purpose.
Shopping for ratings	CRAs are to disclose publicly information about structured finance instruments for which preliminary ratings where requested. (Annex I.D.II.4).	Under agreement between the New York Attorney General and the CRAs of 2008, the latter would charge fees even if the client did not request a rating after a "test rating". Under U.S. Treasury proposal, an issuer will be required to disclose all of the preliminary ratings it had received from different credit rating agencies.

6 – Regulatory Changes in the US vs. EU new initiatives on credit rating agencies

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd) devotes a subsection to the improvement of Nationally Recognised Statistical Rating Organisations (NRSRO) regulation. The act will require changes in the way the SEC regulates NRSRO internal control and procedures, conflicts of interest, rating methodologies and their transparency and performance, rating analyst training, rating symbols and disclosure when issuing ratings of ABS.

Many aspects of the reform are not decided in the regulation itself, but rule-making details are delegated to the Security and Exchange Commission (SEC). On 18 May the SEC published a consultation paper on the proposed implementing rules for a 2 months consultation period. The final SEC rules are expected to enter into force by end of 2011.

A new Office of Credit Ratings is being established at the SEC which will register them and can fine or de-register them. It will also carry out annual examinations of NRSROs and write reports about the results, as well as conduct studies on NRSROs regarding their independence, possible conflicts of interest and the standardising of ratings terminology.

US legislation vs. EU new initiatives on CRAs

Problem area	US legislation	EU new initiatives
1. Reducing overreliance on external ratings	Removing many of the statutory / mandatory requirements for ratings (from Federal Deposit Insurance Act, Investment Company Act, Security Exchange Act, et al.) or replace them with alternative " standards of credit worthiness" as defined by the appropriate regulator. • Alternative standards of creditworthiness:	• Internal risk credit management will be enhanced Credit institutions, investment firms, insurance and reinsurance undertakings, asset managers and investment funds' investment decisions must not rely solely and mechanistically on ratings but

[152] Report on Review of Reliance on Credit Ratings, July 2011, SEC staff.

Problem area	US legislation	EU new initiatives
	on the national level, US federal banking agencies issued an advance notice of proposed rulemaking (ANPR) regarding alternatives to the use of credit ratings in regulatory capital guidelines in August 2010, in response to section 939A of the Dodd-Frank Act. The Act requires federal agencies to assess regulations and substitute references to or requirements for credit ratings with alternative standards of creditworthiness, that are uniform where feasible. The federal agencies (including SEC) also conducted a roundtable to promote the exchange of ideas on the development of alternative creditworthiness standards in November 2010. • Investment managers and institutional investors: in March 2011, the SEC proposed rules that would no longer require a CRA rating for the determination of which securities are permissible investments for a money market fund, and instead would rely on the determination by the fund's board that the security presents minimal credit risks. • Residential and commercial mortgage backed securities in functional regulation: US state insurance regulators no longer use CRA ratings for residential and commercial mortgage backed securities in functional regulation. Rather, independent third parties have been engaged by the National Association of Insurance Commissioners to model potential losses on regulated insurance companies' RMBS and CMBS portfolios. Further measures to reduce reliance have been highlighter in the Report on Review of Reliance on Ratings[152]: • Permission to register primary offerings of non-convertible securities by eligible issuers in forms forms S-3 and F-3 under the Securities Act: reference to NRSRO is proposed to be replaced by the criterion that "the issuer has issued at least $1 billion of non-convertible securities". Equivalent changes or just deletions of references were made in forms S-4 and F-4; F-9; Rule 134, 138, 139 and 168; schedule 14A. • Changes in rules and forms under Investment Company Act of 1940. References to credit ratings assigned by a single NRSRO in the presentation of portfolio holdings in the shareholder reports (forms N-1a, N-2 nd N-3) are proposed to be replaced by funds that choose to use credit quality categorizations. • Changes in rules and forms under	always form their own internal credit opinion on every exposure. (instruments: CRD IV – July 2011; Solvency II – Q1 2012; UCITS and AIFMD – Q2 -2012) • Internal ratings based approaches will be used to calculate capital requirements Institutions with a material number of exposures in a given asset class will need to develop internal models. (instruments: CRD IV – July 2011; Solvency II – Q1 2012) • External ratings will be verified internally Even if institutions do not use internal ratings they will be required to compare their internal credit opinion with the capital requirement resulting from an external rating. (instruments: CRD IV – July 2011; Solvency II – Q1 2012)

Problem area	US legislation	EU new initiatives
	Exchange Act. In the prescription of minimum net capital requirements for broker-dealers (Rule 15c3-1, referred to as the "Net Capital Rule"), all references to credit ratings are substituted by a standard of credit-worthiness: a broker-dealer take a 15% haircut on its proprietary positions in certain securities, unless the broker-dealer establishes, maintains and enforces written policies and procedures, which lead to determination that the investment has only a "minimal amount of credit risk". It is also proposed in the Appendix to the Net Capital Rule to delete references to NRSRO ratings in the term "major market foreign currency". In Appendixes E, G and F, which deal with alternative approaches to computing net capital, SEC proposed to replace references to NRSRO ratings by risk weight (20%, 50%, etc.) Also, an OTC derivatives dealer would be required to request SEC approval to determine credit ratings using internal ratings rather than ratings by NRSROs. Regarding integrity of the securities trading market, rules 101 and 102 of Regulation M are proposed to be changed. References to credit ratings in these rules are replaced with new standards relating to the trading characteristics of covered securities. Specifically, the Commission proposed to except nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities from Rules 101 and 102 if they: (1) are liquid relative to the market for that asset class; (2) trade in relation to general market interest rates and yield spreads; and (3) are relatively fungible with securities of similar characteristics and interest rate yield spreads. The proposal would require a determination to be made using reasonable factors of evaluation and the determination must be subsequently verified by an independent third party. Further removal of references to NRSROs were made in rules 15c3-3 and rule 10b-10. • Further considerations are made by SEC on the following rules: form S-3 under Securities Act, Rule 3a-7 under Investment Company Act and Rule 206(3)-3T under the Advisers Act	
2. Sovereign debt ratings	No specific action. However, rules on methodologies and process of issuing ratings to be strengthened (independent of rating class). E.g. CRA will be required to publish the reasons for a methodology change and have to inform investors	ECB or ESM The ECB or ESM will be encouraged to establish independent credit assessments, particularly for European sovereigns and

Problem area	US legislation	EU new initiatives
	about any significant errors in rating methodologies.	systemic credit institutions. (Instruments: EFSF Regulation)
3. Enhancing competition	A modification to rule 17g-5 of the Securities Exchange Act of 1934 expressly addresses competition where an issuer or arranger pays for a rating for structured finance product. The aims to increase ratings issued for structured finance products and to increase unsolicited ratings. The rule will require the issuer, sponsor or underwriter of structured finance products to maintain a constantly updated website of information relevant to the rating or monitoring of the rating. This website will be accessible to other NRSROs not hired to issue the rating, so that they can issue unsolicited ratings. Other NRSROs accessing the information will be obliged to issue and maintain ratings for 10% of the products for which they access information.	A network of European small and medium size rating agencies A network of European small and medium size rating agencies would be promoted under a European Programme. This could consist of the future Competitiveness and SME programme to be established (as successor of the CIP programme) by the Enterprise and Industry Directorate General or by the "Horizon 2020" programme for innovation related actions managed by DG Research; in both cases, the financing would be possible as of 2014 at the earliest. This network would enable participating small and medium rating agencies to share data, best practice on rating methodologies and resources.
4. Civil liability	Increasing liability of NRSROs if they recklessly or knowingly failed to conduct a reasonable investigation into the facts used by its methodology or verify them if obtain from other parties.	The right of redress will be ensured to investors (Instrument: CRA3)
5. Conflicts of interest	Provisions are included to reduce conflicts of interests among employees of NRSROs. The SEC is tasked with conducting a study on the appropriate methods of paying fees to NRSROs and the resulting conflicts of interest by mid-2012, and on that basis, deciding on a rule of how to select a NRSRO for an initial rating of structured finance product. Concerning the "issuer-pays" model, the SEC is exploring the option of creating a Credit Ratings Board to designate credit rating agencies to rate structured finance instruments.	Rotation of CRAs. An issuer's own credit worthiness could not be rated by the same CRA for more than 3 consecutive years. Another CRA would take over thereafter and the outgoing CRA and the issuer would make available all information accessed in the rating process. (CRA3) A CRA would not be able to rate more than 5 consecutive issues of any asset class by the same issuer, or if fewer than 5 issues are made, it would not be able to rate the issues of one issuer over a period exceeding 3 years. Additional requirements will be introduced on CRAs' independence and objectivity in relation to their shareholders. ESMA would be required to ensure that: (1) shareholders could not either individually or in voting blocs accrue potentially controlling stakes in more than one CRA, (2) that CRAs could not issue ratings for any firm that holds shares in that CRA, even indirectly (3) any person that directly or indirectly controls a CRA would not be allowed to invest in products and entities rated by the CRA and to provide advisory

Problem area	US legislation	EU new initiatives
		services to the entity which or whose products were rated.

ANNEX IV. OVERVIEW OF CRA MARKET

1 – CRAs in the EU

Pursuant to Regulation 1060/2009, all CRAs operating in Europe will have to register with ESMA. Therefore, while there are eight CRAs that have currently completed the registration process, there were 23 applications made between 7 June 2010 and 7 September 2010, in respect of 45 legal entities, so the number of registered CRAs is expected to rise as the applications are processed.[153]

List of registered or certified CRAs

Last update: 31 October 2011

Name of CRA	Country of residence	Registering competent authority of home Member State	Status	Effective date
Euler Hermes Rating GmbH	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	16 November 2010
Japan Credit Rating Agency Ltd	**Japan**	Autorité des Marchés Financiers (AMF)	Certified	6 January 2011
Feri EuroRating Services AG	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	14 April 2011
Bulgarian Credit Rating Agency AD	**Bulgaria**	Financial Supervision Commission (FSC)	Registered	6 April 2011
Creditreform Rating AG	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	18 May 2011
PSR Rating GmbH	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	24. May 2011
ICAP Group SA	**Greece**	Hellenic Capital Market Commission (HCMC)	Registered	7 July 2011
GBB-Rating Gesellschaft für Bonitätsbeurteilung GmbH	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	28 July 2011
ASSEKURATA Assekuranz Rating-Agentur GmbH	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	16 August 2011
Companhia Portuguesa de Rating, S.A. (CPR)	**Portugal**	Comissão do Mercado de Valores Mobiliários (CMVM)	Registered	26 August 2011
AM Best Europe-Rating Services Ltd. (AMBERS)	**United Kingdom**	Financial Services Authority (FSA)	Registered	8 September 2011
DBRS Ratings Limited	**United Kingdom**	Financial Services Authority (FSA)	Registered	31 October 2011
Fitch France S.A.S.	**France**	Autorité des Marchés Financiers (AMF)	Registered	31 October 2011
Fitch Deutschland GmbH	**Germany**	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	31 October 2011
Fitch Italia S.p.A.	**Italy**	Commissione Nazionale per le Società e la Borsa (CONSOB)	Registered	31 October 2011
Fitch Polska S.A.	**Poland**	Komisja Nadzoru Finansowego (KNF)	Registered	31 October 2011

[153] CESR Annual report according to article 21 of Regulation (EC) 1060/2009 on Credit Rating Agencies, CESR/10-1424, 6 December 2010.

Fitch Ratings España S.A.U.	Spain	Comisión Nacional del Mercado de Valores (CNMV)	Registered	31 October 2011
Fitch Ratings Limited	United Kingdom	Financial Services Authority (FSA)	Registered	31 October 2011
Fitch Ratings CIS Limited	United Kingdom	Financial Services Authority (FSA)	Registered	31 October 2011
Moody's Investors Service Cyprus Ltd	Cyprus	Cyprus Securities and Exchange Commission (CySEC)	Registered	31 October 2011
Moody's France S.A.S.	France	Autorité des Marchés Financiers (AMF)	Registered	31 October 2011
Moody's Deutschland GmbH	Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Registered	31 October 2011
Moody's Italia S.r.l.	Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)	Registered	31 October 2011
Moody's Investors Service España S.A.	Spain	Comisión Nacional del Mercado de Valores (CNMV)	Registered	31 October 2011
Moody's Investors Service Ltd	United Kingdom	Financial Services Authority (FSA)	Registered	31 October 2011
Standard & Poor's Credit Market Services France S.A.S.	France	Autorité des Marchés Financiers (AMF)	Registered	31 October 2011
Standard & Poor's Credit Market Services Italy S.r.l.	Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)	Registered	31 October 2011
Standard & Poor's Credit Market Services Europe Limited	United Kingdom	Financial Services Authority (FSA)	Registered	31 October 2011

Source: List of Credit Rating Agencies registered in accordance with Regulation 1060/2009, accessible at http://www.esma.europa.eu/popup2.php?id=8035. Last update: 31.10.2011

CRAs that currently provide sovereign debt ratings[154]

Standard & Poor's with subsidiaries in: FR, DE, IT, ES, SE, UK
Moody's with subsidiaries in: CY, CZ, FR, DE, IT, ES, UK
Fitch with subsidiaries in: FR, DE, IT, PL, ES, UK
DBRS
Capital Intelligence Limited (CY)
Japan Credit Rating Agency Ltd. (JP)

External Credit Assessment Institutions (ECAI)[155]*'s approved by the competent authorities*[156]

[154] This list lists EU based CRAs which are currently providing sovereign debt ratings. It may not be complete and also other CRAs may start rating sovereign debt ratings.

[155] As defined in article 81 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).

[156] ECB response to the public consultation on CRAs: NCBs' contributions as of 13 July 2010.

Table below lists the approved ECAIs by Euro area national banking supervisors (data as of July 2010). It should be noted that the number of approved ECAIs by supervisors exceed that of the Eurosystem in the Eurosystem credit assessment framework (ECAF).[157] Within this framework, the Eurosystem accepts four ECAIs (S&P, Moody's, Fitch and DBRS), National Central Banks in-house credit assessment system source (ICASs)[158] and rating tools such as Lince, ICAP[159] and Coface. Various national banking supervisors have approved at a national level other ECAIs (i.e. Japan Credit Rating Agency, Banque de France, Coface, and Rating and Investment Information (R&I)). During 2009, no new ECAI was approved by national supervisory authorities.

	Moody's	S&P	Fitch	DBRS	Japan Credit Rating (JCR)	Banque de France	Coface	ICAP	Lince	R&I
BE	x	x	x		x	x				x
DE	x	x	x	x	x					
GR	x	x	x					x		
IE	x	x	x	x	x					
ES	x	x	x							
FR	x	x	x	x	x	x	x			x
IT	x	x	x						x	
LU	x	x	x		x					
NL	x	x	x	x						
AT	x	x	x	x						
PT	x	x	x				x			
FI	x	x	x	x						
SI	x		x				x			
CY	x	x	x							
MT	x	x	x							
SK	x	x	x							

Source: ECB response to the public consultation on CRAs: NCBs' contributions as of 13 July 2010.

2 – Market Concentration within the Rating Industry

Market share of outstanding ratings by rating agencies in the US for industrial corporations and financial institutions end 2009 was the following:

[157] The Eurosystem credit assessment framework (ECAF) defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met. In the assessment of the credit standard of eligible assets, the Eurosystem takes into account credit assessment information from credit assessment systems belonging to one of four sources, namely external credit assessment institutions (ECAIs), NCBs' in-house credit assessment systems (ICASs), counterparties' internal ratings-based (IRB) systems, or third-party providers' rating tools (RTs). Additionally, in the assessment of the credit standard the Eurosystem takes into account institutional criteria and features guaranteeing similar protection for the instrument holder such as guarantees. More information can be found on: www.ecb.europa.eu.

[158] Currently Banco de España, the Banque de France, the Central Bank of Ireland, the Deutsche Bundesbank, and the Oesterreichische Nationalbank have set up a ICAS facility.

[159] Lince is recognised as an ECAI for Capital Requirements purposes by Banca d'Italia and is recognised as a Rating Tool for ECAF purposes. ICAP is recognised as an ECAI for Capital Requirements purposes by Bank of Greece and is recognised as a Rating Tool for ECAF purposes.

	Industrial corporations	Financial institutions
Standard & Poor's	43,2%	24,0%
Moody's	32,3%	35,1%
Fitch	13,1%	33,0%
TOP 3 rating agencies	88,6%	92,1%
others	11,4%	7,9%

Source: Lynn Bai, The performance Disclosures of Credit Rating Agencies: are they effective reputational sanctions, New York University Journal of Law & Business, 2010, p.32.

This data shows that the three largest CRAs had a share of respectively 88,6% and 92,1% of ratings for respectively industrial corporations and financial institutions end 2009. Similar market shares can be expected for other rating segments and territories, and applies also for credit ratings within the EU.

The table below presents a non-exhaustive list of acquisition by three largest CRAs.

2000	Duff & Phelps (États-Unis)	Fitch IBCA
2000	Thomson Financial BankWatch (Canada)	Fitch IBCA
2000	AMR (France)	Fitch IBCA
2000	Crowe, Chizek & Company LLP (États-Unis)	Moody's
2000	Canadian Bond Rating Service (Canada)	S&P
2001	Central European Rating Agency (Pologne)	Fitch
2001	Magister (Argentine)	Moody's
2001	Charter Research (États-Unis)	S&P
2002	Credit Ratings System (États-Unis)	Fitch
2002	KMV (États-Unis)	Moody's
2003	Atlantic Rating (Brésil)	Fitch
2004	Interfax Rating Agency (Russie)	Moody's
2004	Capital IQ (États-Unis)	S&P
2005	Algorithmics (Canada)	Fitch
2005	ValuSpread (Grande-Bretagne)	Fitch
2005	Economy.com (États-Unis)	Moody's
2005	Assirt Research (Australie)	S&P
2005	CRISIL (Inde)	S&P
2005	Taiwan Ratings (Taiwan)	S&P
2006	Reoch Credit Ltd (Grande-Bretagne)	Fitch
2006	CRA Rating (République tchèque)	Moody's
2006	Wall Street Analytics (États-Unis)	Moody's
2007	GSCS (Dubaï)	Fitch
2007	PT Kasnic Credit Rating Indonesia (Indonésie)	Moody's
2007	CA Ratings (Afrique du Sud)	Moody's
2007	Imake Consulting (États-Unis)	S&P
2007	ABSXchange (États-Unis)	S&P
2007	ClariFi (États-Unis)	S&P
2008	BQuotes (États-Unis)	Moody's
2008	Fermat International (Belgique)	Moody's
2008	Enb Consulting (Grande-Bretagne)	Moody's

Source: Norbert Gaillard (2007): “les méthodologies de notation souveraine”, thèse de doctorat en économie, Institut d’études politiques de Paris

3 – Overview of the "big three" CRAs

Organisation and financial performance

These entities of Standard and Poor's Moody's and Fitch have their head offices and main management, administrative and supervisory bodies in the US (although Fitch Ratings is dual headquartered in New York and London). They operate in the EU through subsidiaries established in several countries.[160] Their activity does not have a territorial character.

Moody's Investor Services is owned by Moody's Corporation (listed on the New York Stock Exchange - NYSE). Standard & Poor's is owned by the American publisher Mc Graw-Hill (which is a listed entity on the NYSE). Fitch is a subsidiary of the French financial company Fimalac (listed on Euronext Paris).[161]

Standards and Poor's

Standard and Poor's Ratings Services is a division of Standard and Poor's (S&P), a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), a U.S. listed publishing and information services group.

In the E.U, S&P operates in France, Germany, Italy, Spain, Sweden and the UK via local subsidiaries, branches or divisions of McGraw-Hill:

- Standard & Poor's España, S.A. (Spain)
- McGraw Hill International (U.K.) Limited (UK)
- Standard & Poor's AB (Sweden)
- The McGraw-Hill Companies GmbH (Germany)
- The McGraw-Hill Companies, SA (France)
- The McGraw Hill Companies, SRL (Italy)

As S&P's ratings are issued from an entity that also conducts other business (for example, maintaining financial indices) making it difficult to locate financial information referring only to the ratings business.

In 2010, Standard & Poor's (including non-ratings activity), increased profits in absolute terms, but fell slightly in terms of operating margin. The operating margin was nonetheless significant at 45%:

Revenue ($ million)	**2010**	**2009**	**2008**
Transaction	662.5	549.8	554.9
Non-transaction	1032.9	987.5	1028.1
Total revenue	1695.4	1537.3	1583
Operating profit	762.4	712.2	749.3
% Operating margin	**45.0**	**46.3**	**47.3**

Source: McGraw Hill 2010 Annual Report, p. 24, accessible at: http://www.mcgraw-hill.com/about/annual_report/ar2010.pdf.

Some estimates have placed the operating margin for the ratings section of the business on its own at 50% in recent years.[162]

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[160] Standard &Poor's has subsidiaries in France, Germany, Italy, Spain, Sweden and UK; Moody's has subsidiaries in Bulgaria, Cyprus, Czech Republic, France, Germany, Italy, Spain and UK. Fitch has subsidiaries in UK ("Fitch Europe"), France, Germany, Italy, Poland and Spain.

[161] Fitch merged in 1997 with the British IBCA rating company, which is specialised in rating banks. Fitch-IBCA then bought the fourth-largest American rating agency, Duff & Phelps, in June 2000 and, in December 2000, Thomson BankWatch, another agency specialised in rating banks.

[162] The Credit Rating Industry: Competition and Regulation, Fabian Dittrich, p. 20. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821.

S&P published 870,000[163] new and revised ratings in 2009. Ratings are issued for a number of different sectors, such as structured finance, sovereign and corporate. Although S&P does not appear to publish a detailed distribution of the ratings and revenue by region and sector, S&P does note that a fall in the issuance of ABS and RMBS declined in the US and Europe in 2010, resulting in lower structured finance revenues. [164] S&P rates 126 sovereign governments.[165]

In the absence of S&P revenues by geographich region, the table below shows McGraw Hill revenues

Revenue ($ million)	**2010**		**2009**		**2008**	
US	4367.4	70.8%	4226.4	71.0%	4579.4	72.1%
European Region	987.2	16.0%	963.7	16.2%	1020.5	16.1%
Asia	499.4	8.1%	467.8	7.9%	438.8	6.9%
Rest of the world	314.3	5.1%	293.9	4.9%	316.4	5.0%
Total	**6168.3**		**5951.8**		**6355.1**	

Source: McGraw Hill 2010 Annual Report, p. 64, accessible at: http://www.mcgraw-hill.com/about/annual_report/ar2010.pdf.

Moody's Investors Service

Moody's Corporation, based in the U.S., has a number of subsidiaries in various jurisdictions.[166] Its ratings business is primarily associated with Moody's Investors Service Inc ("MIS"), based in Delaware, U.S. MIS claims to rate or analyse debt in more than 110 countries, 25,000 public finance issuers, 12,000 corporate issuers and 106,000 structured finance obligations, employing 2,700 staff, including 1,200 analysts. 640 of the total staff are employed in the EU by MIS EU subsidiaries and one branch. [167]

MIS has the following seven EU subsidiaries[168]:

- Moody's Investors Service Ltd, (UK) (includes its Czech branch, Moody's Investors Service Ltd, organizační složka),
- Moody's EMEA Ltd,
- Moody's Deutschland GmbH,
- Moody's France SAS,
- Moody's Investors Service España S.A.,

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163 Standard and Poor's website, About Standard and Poor's. Available from: http://www.standardandpoors.com/about-sp/main/en/eu.

164 McGraw Hill 2010 Annual Report p 24 – 25. Available from: http://www.mcgraw-hill.com/about/annual_report/ar2010.pdf.

165 Standard and Poor's request for comment on Sovereign Government Rating Methodology And Assumptions, p 7, available from: http://www.interest.co.nz/sites/default/files/S&P%20Sovereign%20Government%20Rating%20Methodology%20And%20Assumptions%20RFC.pdf.

166 For a complete list of subsidiaries, see Moody's Corporation Form 10-K (Annual Report) filed with the SEC, available from: http://www.sec.gov/Archives/edgar/data/1059556/000119312511047974/d10k.htm, and Exhibit 21 of this filing, available from: http://www.sec.gov/Archives/edgar/data/1059556/000119312511047974/dex21.htm.

167 European Union Transparency Report issued in respect of the year ended 31 December 2010, published March 2011, p 2, available from: http://www.moodys.com/PublishingImages/MCO/EU%20Transparency%20Report%202010.pdf.

168 European Union Transparency Report issued in respect of the year ended 31 December 2010, published March 2011, p 8, available at: http://www.moodys.com/PublishingImages/MCO/EU%20Transparency%20Report%202010.pdf.

- Moody’s Investors Service Cyprus Ltd, and
- Moody’s Italia S.r.l.

Moody's Corporation also includes details of revenue by sector and geographic jurisdiction in its Annual Reports. MIS issues ratings in the corporate finance, structured finance, financial institutions and public sector areas. The following table gives a breakdown of MIS revenue in these four sectors:

Revenue ($ million)	**2010**		**2009**		**2008**	
Corporate finance	563.9	38.5%	408.2	31.9%	307.0	24.2%
Structured finance	290.8	19.8%	304.9	23.9%	404.7	31.9%
Financial institutions	278.7	19.0%	258.5	20.2%	263.0	20.7%
Public, project, infrastructure	271.6	18.5%	246.1	19.3%	230.0	18.1%
Other	61.3	4.2%	60.0	4.7%	63.6	5.0%
Total	**1466.3**		**1277.7**		**1268.3**	

Source: Moody's Corporation Form 10-K (Annual Report 2011), p 99, filed with the SEC, available at: http://www.sec.gov/Archives/edgar/data/1059556/000119312511047974/d10k.htm.

These data show the declining role of structured finance in generating revenues falling from 31.9% in 2008 to 19.8% in 2010, which is in line with an expected fall in structured finance product issuance since the crisis.

In the absence of a geographic breakdown of revenue for Moody's Investors Service, the table below shows that over half of the Corporation's consolidated revenue derives from the US, and a still significant proportion derives from the EMEA area. In 2009, 71% of Corporation's consolidated revenue is derived from Moody's Investors Service:

Revenue ($ million)	**2010**		**2009**		**2008**	
US	1089.5	53.6%	920.8	51.2%	910.1	51.8%
EMEA	627.4	30.9%	624.7	34.8%	603.1	34.4%
Other	315.1	15.5%	251.7	14.0%	242.2	13.8%
Total	**2032.0**		**1797.2**		**1755.4**	

Source: Moody's Corporation Form 10-K (Annual Report 2011), p 99, filed with the SEC, available at: http://www.sec.gov/Archives/edgar/data/1059556/000119312511047974/d10k.htm.

These data show that revenues from the EMEA area continue to provide over 30% of revenue for the Corporation (these figures include businesses other than MIS). Although separate EU data are not published in these filings, it is reasonable to assume based on the office locations of MIS that a large proportion of MIS's EMEA revenue is derived from the EU.

Fitch Ratings

Fitch operates through subsidiaries in the EU. The subsidiaries outside the UK are owned by Fitch Ratings Ltd. of the UK, itself owned by Fitch, Inc. of the US. These are the subsidiaries of Fitch Ratings in the EU:

- Fitch Ratings Limited (UK)
- Fitch Ratings CIS Limited (UK)
- Fitch Ratings España S.A.U (Spain)
- Fitch Ratings Deutschland GMBH (Germany)
- Fitch France (France)
- Fitch Italia S.P.A. (Italy)
- Fitch Polska S.A. (Poland)

Fitch Ratings generated revenues of $657.2 million during the 2010 fiscal year, a 7.8% increase from $609.8 million for the prior year. After translation into euros, its contribution to consolidated revenue came to €487.5 million versus €450.2 million for the previous period, an increase of 8.3% on a reported basis and 6.3% like-for-like[169]. The table below the revenue distribution by geographic region.

Revenue (in %)	2010	2009
United States	36.1%	37.9%
United Kingdom	11.5%	10.0%
Other European Union countries	21.6%	23.6%
Other countries	30.8%	28.5%

Source: 2010 Fimalac Annual Report, p 15: http://www.fimalac.com/annual-reports.html.

Ultimately controlled in Europe (unlike the other two large CRAs), by the French parent company Fimalac, Fitch Ratings generates a large share of its revenue from the U.S., at nearly 36% in 2010, but with a comparable 33% from EU countries.

Though revenues at Fitch Ratings are significantly lower than at S&P and MIS, Fitch claims that its market share of global debt issuance, measured in terms of dollar issuance volume, stood at an estimated 68%. [170] The table below lists global market share for the individual sectors where Fitch is an active player.

Non-Financial Corporates	57%
Financial Institutions	86%
Structured Finance	48%
US Public Finance	60%
Sovereigns	91%
Total	**68%**

Source: 2010 Fimalac Annual Report, p 18: http://www.fimalac.com/annual-reports.html.

Fitch Ratings currently maintains coverage of approximately 6,000 financial institutions, including over 3,500 banks and 1,400 insurance companies. Finance & leasing companies, broker-dealers, asset managers, managed funds, and covered bonds make up the remainder of its financial institution coverage universe. Additionally, the agency currently rates more than 2,000 corporate issuers, 100 sovereigns, 200 subsovereigns, 300 global infrastructure ratings, and 46,000 US municipal transactions. It also maintains surveillance on over 6,500 US, 1,300 European and 800 Asian structured finance transactions.[171]

Profitability of three largest CRAs

Over the years, there have been shifts in the revenue structure of the leading CRAs. Until the mid-1990s, CRAs specialised in and derived most of their revenues from the rating of corporate or sovereign debt. However, with the growth of structured markets they increasingly engaged in the highly lucrative activity of rating then new structured finance transactions. As a consequence, CRAs earned up to approximately 50% of their revenue from structured finance ratings.[172] According to the SEC, between 2002 and 2006, revenues derived from rating structured products increased dramatically: "revenues derived from

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169 2010 Fimalac Annual Report, p 17. Available from: http://www.fimalac.com/annual-reports.html.

170 Ibid, p. 15.

171 Ibid.

172 In accordance with a Report on rating agencies published by the French Autorité des Marchés Financiers for 2006 the ratings income of the agencies in Europe represented in 2006 between 16% and 30% of worldwide income, with transactions in the United States representing more than half of the income of the agencies. Structured finance business represented between 35% and 45% of European earnings. See AMF 2006 Report on rating agencies, Part I, Credit rating of corporate issuers and structured finance, 26.01.2007, p. 11. Available from: http://www.amf-france.org/documents/general/7640_1.pdf.

RMBS ratings increased between 2002 and 2006 by a percentage that varied among the three largest NRSROs from approximately 100% for the firm which had the lowest percentage growth in revenues to over 200% for the firm which had the highest percentage growth. For CDOs, during the same period, ratings revenue increased by a percentage that varied from approximately 200% for the firm which had the lowest percentage growth to over 800% for the firm which had the highest percentage growth."[173]

The tables below give a comparison of the relatively high profit margins of the major CRAs.

S&P		2010	2009	2008
	($ million)			
	Total revenue	1.695,4	1.537,3	1.583,0
	Operating profit	762,4	712,2	749,3
	%	*45,0%*	*46,3%*	*47,3%*
Moody's Investor Services				
	($ million)			
	Total revenue	1.466,3	1.277,7	1.268,3
	Operating profit	649,4	557,2	600,6
	%	*44,3%*	*43,6%*	*47,4%*
Fitch Ratings				
	(€ million)			
	Total revenue	N/A	450,4	486,8
	Operating profit	N/A	178,0	159,0
	%	*N/A*	*39,5%*	*32,7%*

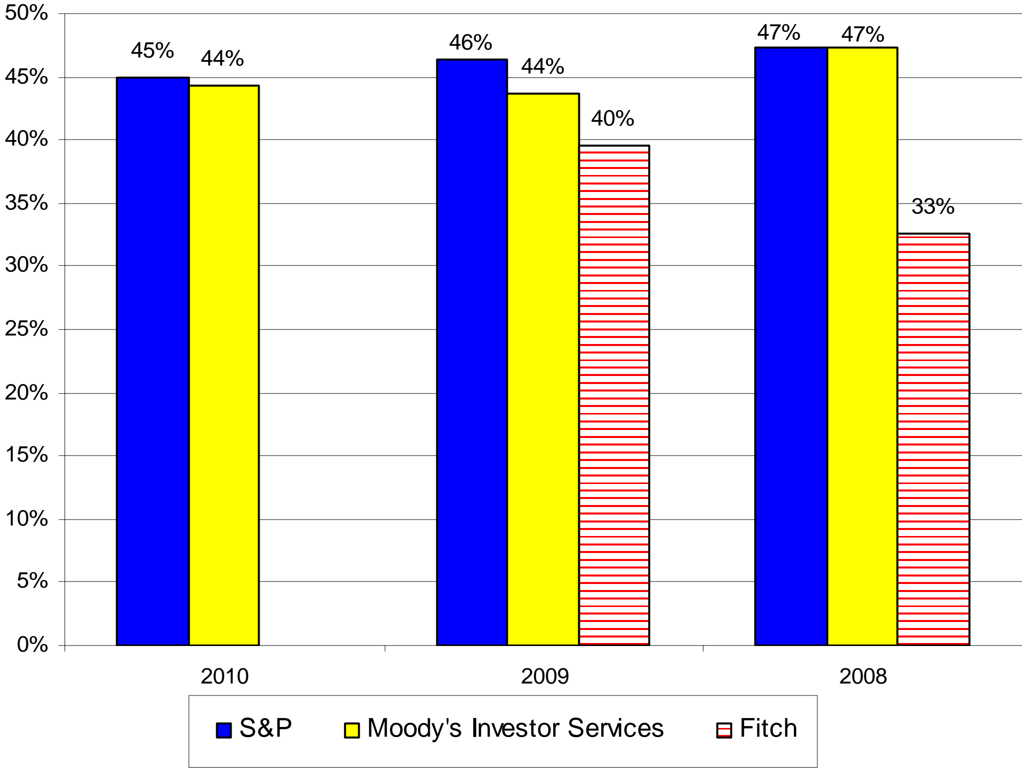

***Figure 1**. Profit margins of three largest CRAs*

Shareholding structure

Figures 2 and 3 below detail a group of shareholders who collectively own simultaneously 37.9% of shares in The McGraw-Hill Companies (which wholly owns S&P) and 53.0% of shares in Moody's.

[173] 2011 Annual Report on Nationally Recognised Statistical Ratings Organisations, SEC, p22.

The group, aligned by shareholdings in the two largest CRAs, is composed of large financial services companies such as Northern Trust Corporation, State Street Corporation, Black Rock Inc, Bank of New York. Other firms that do not hold shares in one or the other of these CRAs also have significant holdings, which are also indicated.

N°	Group of Shareholders	Current situation	
		S&P's	Moody's
1	Northem Trust Corp	1,75%	1,32%
2	Capital Group Companies	16,15%	21,98%
3	Vanguard Group Inc.	4,44%	3,97%
4	State Street Corp.	4,41%	3,91%
5	T. Rowe Price Associates	3,90%	3,98%
6	Fidelity Investments	1,27%	8,15%
7	Black Rock Inc.	4,59%	6,89%
8	Bank of New York	1,23%	2,25%
9	Massachuset. Financial Services	0,21%	0,62%
		38%	**53%**

Figure 2. *Group of shareholders who collectively own S&P's and Moody's*

Sources: Roland Berger Strategy Consultants, research from Bloomberg, websites of investors and the CRAs, May 2011.

Figure 4 shows shareholdings by the companies aligned by shareholdings in S&P and Moody's, or with significant holdings in one or the other of these CRAs. Companies' (on the left) holdings in the other companies in the group (including in their own shares) can be read across the matrix. For example, Northern Trust holds 6.55% of its own shares, 4.01% of CRG's shares, and so on.

The final row at the bottom of the matrix shows the total holdings of the group in each of the companies listed across the top of the matrix. For example, the group holds collectively 21.67% of State Street and 16.72% of Black Rock Inc.

The data in this table are not necessarily complete – there may be further cross shareholdings not yet indicated.

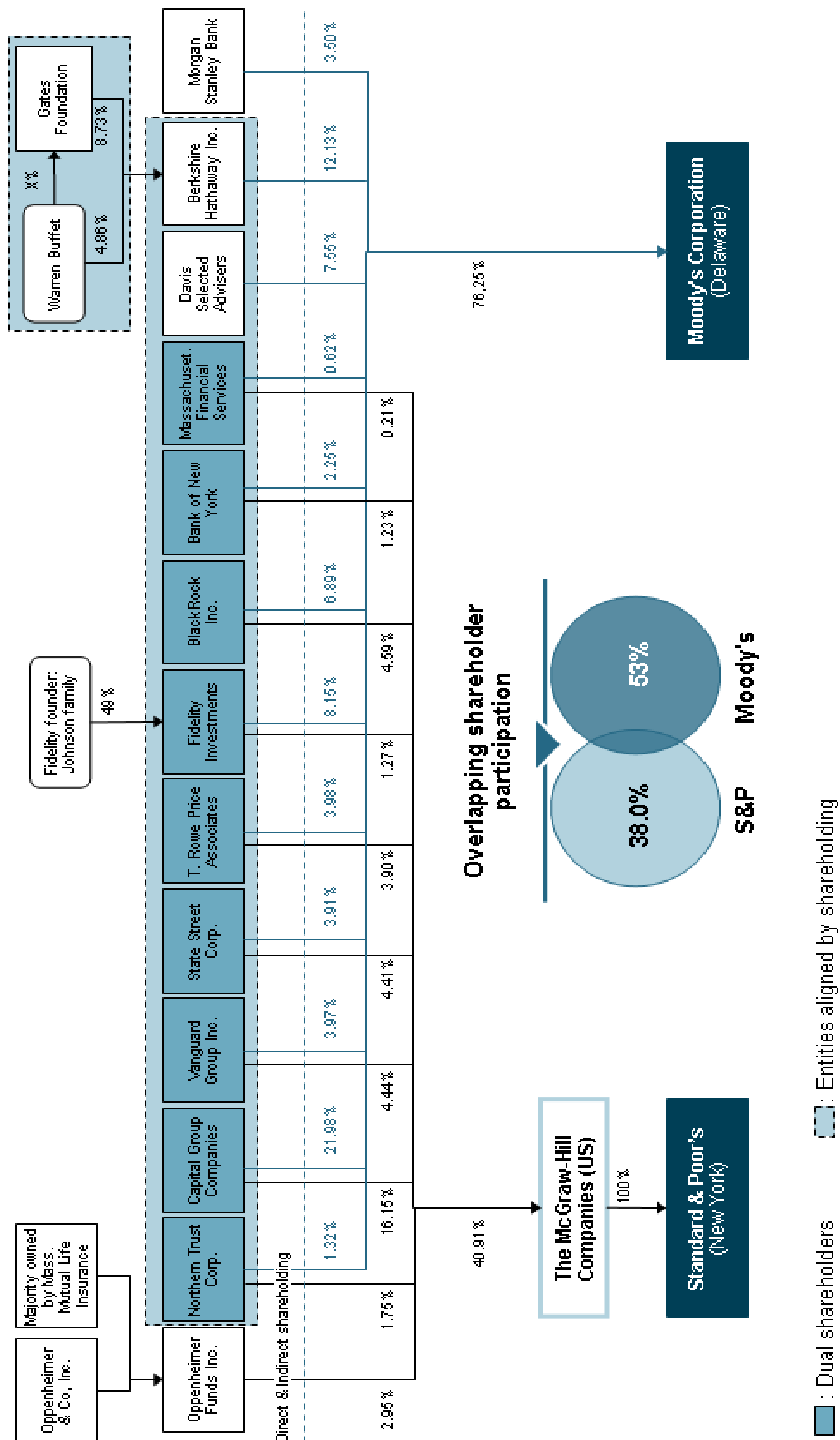

Figure 3 *Shareholder structure of S&P and Moody's*
Sources: Roland Berger Strategy Consultants, research from Bloomberg, websites of investors and the CRAs, May 2011.

SHAREHOLDER	PARTICIPATION											
	Northern Trust	CRG	CWI	Vanguard Group	State Street	T. Rowe Price	Fidelity Invest.	Black Rock Inc.	Bank of New York	Mass. Fin. Serv.	Davis Sel. Advisers	Berkshire Hathaway
Northern Trust	6.55%	4.01%	2.92%	3.50%	3.58%	4.37%	1.14%	2.43%	0.94%			
CRG (Capital Group)												
CWI (Capital Group)												
Vanguard Group												
State Street	1.31%	4.73%	2.79%	3.66%	4.51%	2.45%	3.56%	2.44%	1.37%	5.13%		
T. Rowe Price Assoc.	1.25%			3.95%	2.53%		1.80%	2.56%	1.18%			
Fidelity Investments												
BlackRock Inc.	0.31%			0.66%	0.43%		0.66%	0.61%	0.33%			
Bank of New York	1.32%	3.64%	1.33%	3.49%	3.53%	1.25%	1.24%	2.45%		5.13%	6.44%	
Mass. Fin. Serv.												
Davis Sel. Advisers												
Berkshire Hathaway	1.89%			4.11%	6.09%	0.57%	0.76%	3.23%	1.50%		0.49%	
Sum	**12.63%**	**12.38%**	**7.04%**	**19.37%**	**21.67%**	**8.64%**	**9.16%**	**16.72%**	**5.32%**	**10.26%**	**6.93%**	**0.00%**

Holding of own shares

Figure 4. *Cross shareholdings of Moody's and S&P shareholders*
Sources: Roland Berger Strategy Consultants, research from Bloomberg, websites of investors and the CRAs, May 2011.

ANNEX V. OVERVIEW OF RECENT VOLUNTARY INITIATIVES UNDERTAKEN BY MAJOR CRAs TO ENHANCE RATINGS QUALITY

Standards and Poor's (S&P)

Since announcing an initiative on 7 February 2008, focusing on enhancing various areas comprising governance, analytics, transparency of information and addressing education issues, S&P has put a number of implementing actions in place. The following actions are mentioned in the most recent update relating to this programme:

- In February 2009 the firm's appointed Ombudsman began work, after appointment in January by the McGraw Hill Audit Committee.
- Further steps have been taken to ensure the independence of ratings analysts, as introducing separation between analysts and other areas including policy governance, criteria management and development and quality assurance.
- There have been a number of organisational changes, intended to increase the independence of various groups and ultimately ensure the independence of ratings issued by S&P[174].
- In the area of activity of the analysts, S&P has introduced a separate group charged with model validation and increased its ongoing education requirements for analysts. New measures relating to CDS, bond and loan spreads are now highlighted in analysis.
- In the area of transparency, S&P will cease providing ratings for some products whose sponsors or issuers do not agree to the publication of certain information. S&P has also developed earl warning indicators in relation to structured finance products.

After launching a consultation paper in November 2010, S&P updated their sovereign debt rating methodology.[175] (see figure 1.).

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[174] See Standard and Poor's "Standard and Poo'r commitment: Quality and Independence" on 4.8.2009

[175] Sovereign Government Rating Methodology and Assumptions, Standard & Poor's, June 30 2011

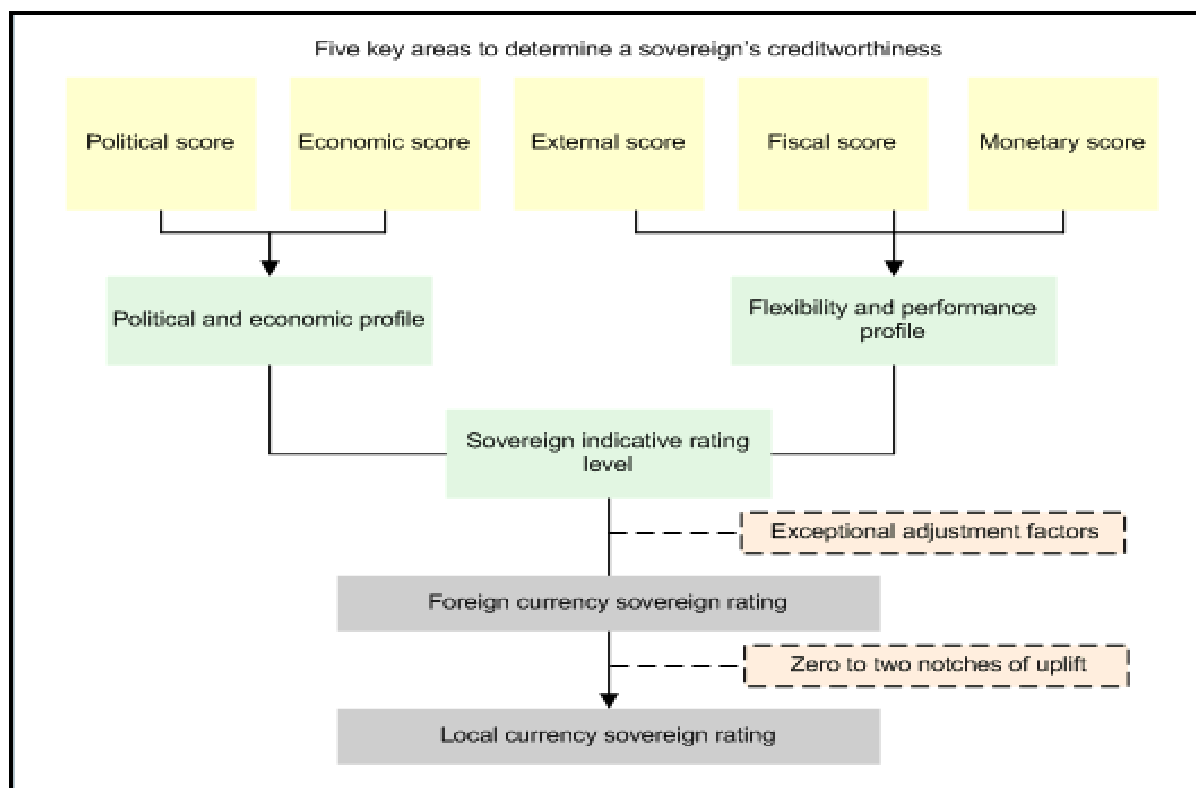

Figure 1. *S&P's Sovereign Rating Framework*

The update is intended to provide additional clarity by introducing a finer calibration of the five major rating factors that form the foundation of a sovereign analysis and by articulating how these factors combine to derive a sovereign's credit ratings

Standard & Poor's analysis of a sovereign's creditworthiness starts with its assessment and scoring of five key rating factors. Each factor receives a score, using a six-point numerical scale from '1' (the strongest) to '6' (the weakest). A series of quantitative factors and qualitative considerations form the basis for assigning the scores. The criteria then combine those five scores to form a sovereign's "political and economic profile," and its "flexibility and performance profile".

- The political and economic profile reflects the view of the Agency of the resilience of a country's economy, the strength and stability of the government's institutions, and the effectiveness of its policy-making. It is the average of the political score and the economic score.
- The flexibility and performance profile reflects the Agency's view of the sustainability of a government's fiscal balance and debt burden, in light of the country's external position, as well as the government's fiscal and monetary flexibility. It is the average of the external score, the fiscal score, and the monetary score.

Those two profiles are then used in figure 2. to determine an indicative rating level.

The sovereign (foreign-currency) rating would in most cases fall within one notch of the indicative rating level, based on the sovereign's positioning relative to peers. For example, for a sovereign having a "moderately strong" political and economic profile and a "very strong" flexibility and performance profile, the Agency would most likely assign a rating within one notch of 'AA-'.

Flexibility and performance profile	Category	Superior	Extremely strong	Very strong	Strong	Moderately strong	Intermediate	Moderately weak	Weak	Very weak	Extremely weak	Poor
Category	Score	1	1.5	2	2.5	3	3.5	4	4.5	5	5.5	6
Extremely strong	1 to 1.7	aaa	aaa	aaa	aa+	aa	a+	a	a-	bbb+	N/A	N/A
Very strong	1.8 to 2.2	aaa	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb-
Strong	2.3 to 2.7	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb	b+
Moderately strong	2.8 to 3.2	aa+	aa	aa-	a+	a-	bbb	bbb-	bb+	bb	bb-	b+
Intermediate	3.3 to 3.7	aa	aa-	a+	a	bbb+	bbb-	bb+	bb	bb-	b+	b
Moderately weak	3.8 to 4.2	aa-	a+	a	bbb+	bbb	bb+	bb	bb-	b+	b	b
Weak	4.3 to 4.7	a	a-	bbb+	bbb	bb+	bb	bb-	b+	b	b-	b-
Very weak	4.8 to 5.2	N/A	bbb	bbb-	bb+	bb	bb-	b+	b	b	b-	b-
Extremely weak	5.3 to 6	N/A	bb+	bb	bb-	b+	b	b	b-	b-	ccc/cc	ccc/cc

Figure 2. *Indicative Rating level from the combination of the two profiles*

A sovereign (foreign-currency) rating might differ by more than one notch compared with the indicative rating level if it meets one or more of the following exceptional characteristics below:

- Extremely weak external liquidity.
- Extremely weak fiscal situation
- Exceptionally large net general government asset position
- Very high political risk and high debt burden
- Rescheduling risk
- High security risk
- Severe natural catastrophes

If a sovereign combines several of the exceptional factors, its foreign-currency rating would be adjusted by the cumulative effect of those adjustments. Those exceptional adjustments are based on a forward-looking analysis.

The analysis of each of the key five factors mentioned above embodies a combination of quantitative and qualitative elements. Some factors, such as the robustness of political institutions, are primarily qualitative, while others, such as the economy, debt, and external liquidity use mostly quantitative indicators.

Moody's

Starting in August 2008, Moody's has began to issue a series of ' Special Comment' documents in relation to its global credit policy, detailing measures taken to strengthen the

quality, transparency and independence of ratings.[176] Updates provided in December 2008 and August 2009 indicated progress on these measures.[177] The latter report outlines progress in the six broad areas that Moody's is targeting in these initiatives:

- Strengthening Analytical Integrity of Ratings
- Enhancing Consistency Across Rating Groups
- Improving Transparency of Ratings and the Ratings Process
- Increasing Resources in Key Areas
- Bolstering Measures to Manage Conflicts of Interest
- Pursuing Industry and Market-Wide Initiatives

In addition, in September 2008, Moody's Global Sovereign published its rating methodology for sovereign debt. The paper aims at increasing transparency by further clarifying the areas that Moody's takes into account when issuing its sovereign ratings so that market participants are better informed.[178]

The document stresses the importance of interpreting quantitative factors through qualitative perspectives and without relying on any measure mechanistically.[179] Moody's sovereign ratings take into account four main areas: economic strength; institutional strength; government financial strength; susceptibility to event risk. These areas are further divided and have different interactions in order to form a basis on which the final rating judgement is made (see figure 3 below)

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176 European Union Transparency Report issued in respect of the year ended 31 December 2010, published March 2011, pp 2 – 3, available from: http://www.moodys.com/PublishingImages/MCO/EU%20Transparency%20Report%202010.pdf.

177 See Strengthening Analytical Quality and Transparency, An Update on Initiatives Implemented by Moody’s in the Past Twelve Months, August 2008 (Document No. 110613), Strengthening Analytical Quality and Transparency, An Update on Initiatives Implemented by Moody’s in the Past Eighteen Months, December 2008 (Document No. 113751), available from: http://v2.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20Pages/Products%20and%20Services/Downloadable%20Files/Strengthening%20Analytical%20Quality%20and%20Transparency.pdf, and Strengthening Analytical Quality and Transparency, An Update on Initiatives Implemented by Moody’s Over the Past Two Years, August 2009 (Document No. 119843), available from: http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_119843.

178 Rating Methodology, Sovereign Bond Ratings, Moody's Investors Service, September 2008, p 1, available at: http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_109490.

179 Ibid.

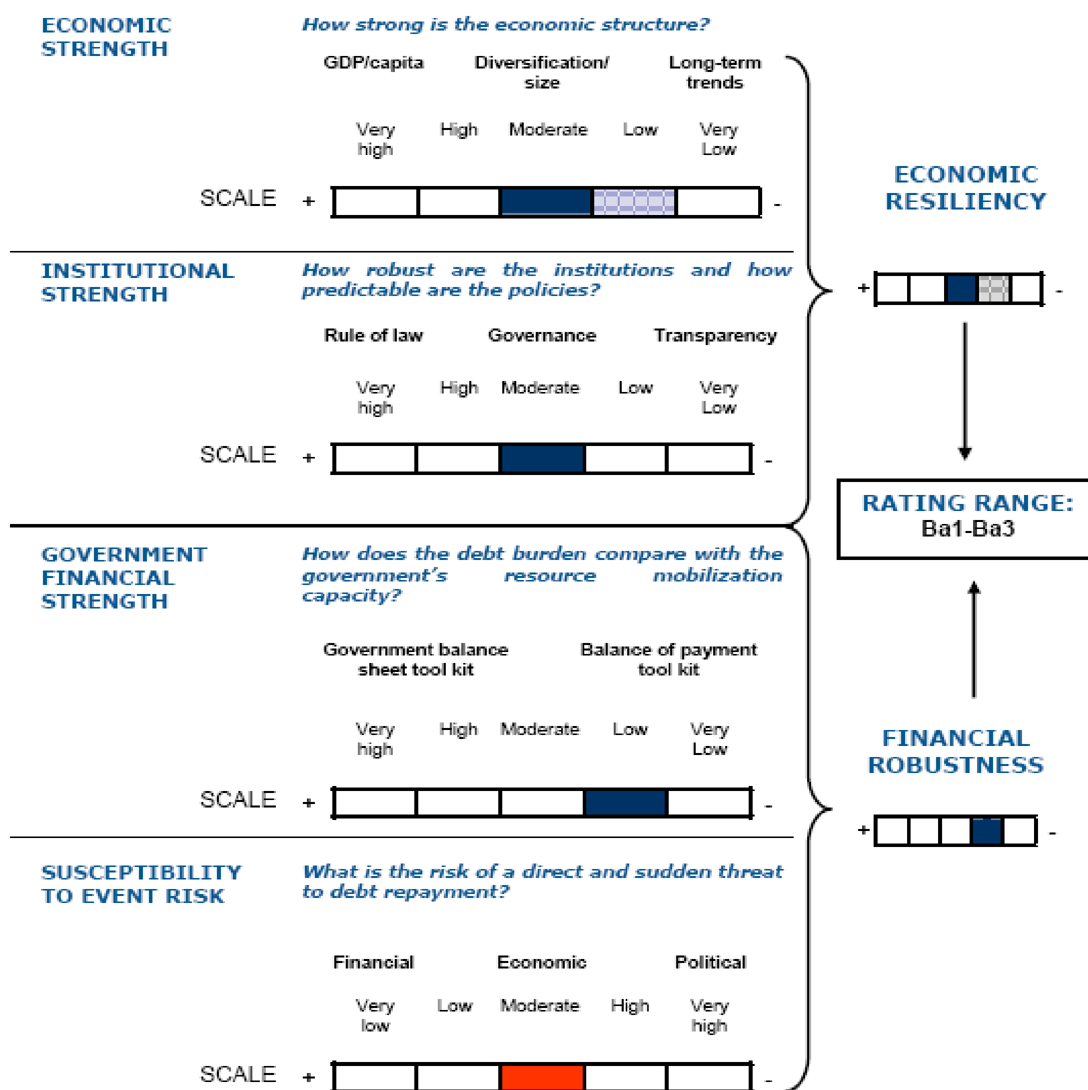


Figure 3. *Moody's Sovereign Rating Mechanics: example of country A*

The first step consists in determining the shock-absorption capacity of the country, based on the combination of two key factors:

- The country's economic strength, captured in particular by the GDP per capita – the single best indicator of economic robustness and, in turn, shock-absorption capacity.
- The institutional strength of the country, the key question being whether or not the quality of a country's institutional framework and governance – such as the respect of property right, transparency, the efficiency and predictability of government action, the degree of consensus on the key goals of political action – is conducive to the respect of contracts.

Combining these two indicators helps determine the degree of resiliency, and position the country in the rating scale: very high, high, moderate, low or very low.

The second step focuses directly on debt matters, and especially the combination of two other factors:

- The financial strength of the government. The question is to determine what must be repaid (and how "tolerable" the debt is) and the ability of the government to mobilize resources: raise taxes, cut spending, sell assets, obtain foreign currency

- The susceptibility to event risk – that is the risk of a direct and immediate threat to debt repayment, and, for countries higher in the rating scale, the risk of a sudden multi-notch downgrade. The issue is to determine whether the debt situation may be (further) endangered by the occurrence of adverse economic, financial or political events.

Combining these two indicators helps determine degrees of financial robustness and refine the positioning of the country on the rating scale.

The third stage consists in adjusting the degree of resiliency to the degree of financial robustness. This results in the identification of a rating range (see figure V.4).

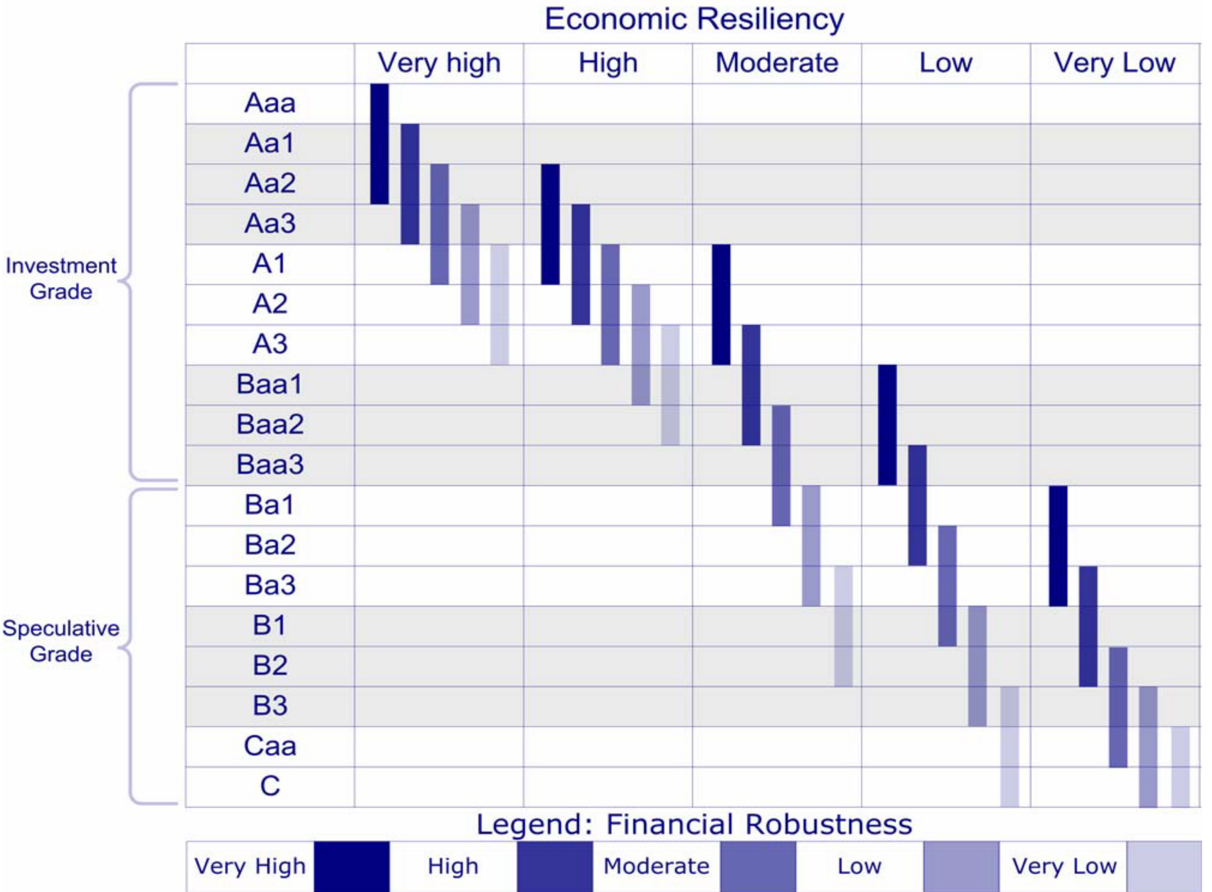


Figure 4. *Sovereign rating Road Map*

The final determination of the sovereign bond rating is based on the output of the "rating road map" (see below), combined with all additional information that a rating committee will deem relevant to assess the creditworthiness of a government. The determination of the exact rating is done on the basis of a peer comparison, and weighting additional factors that may not have been adequately captured earlier.

Fitch, Inc.

After separating in 2008 its non-rating business into a separate division, Fitch Solutions, which focuses on risk, analytical and data tools, including distribution of ratings issued by Fitch Ratings, and a number of other initiatives intended to enhance the quality of ratings, Fitch Ratings, like the other two large rating agencies, has also issued its sovereign rating methodology.[180]

[180] Master Criteria: Sovereign Rating Methodology, issued on 16 October 2009, and updated on 16 August 2010, available from http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=547765.

The recently updated methodology of Fitch Rating, similarly to what happens for the other two large rating agencies, is based upon the interplay of qualitative as well as quantitative inputs into the ratings process[181].

Fitch's approach to sovereign risk analysis is presented as a synthesis of quantitative and qualitative judgements that try to capture the willingness as well as the capacity of the Country to meet its debt obligations.

The sovereign rating analysis incorporates a wider range of factors than only the financial strength of the sovereign and includes an assessment of the following (see detail in figure 5. below):

- macroeconomic performance and prospects;
- structural features of the economy that render it more or less vulnerable to "shocks", including the risks to macroeconomic stability and public finances posed by the financial sector, as well as "political risk" and governance factors;
- public finances, including the structure and sustainability of public debt as well as fiscal financing; and
- external finances, with a particular focus on the sustainability of international trade balances, current account funding and capital flows, as well as the level and structure of external debt (public and private).

Sovereign Rating Model – Independent Variables

Variable	Derivation and description
Macroeconomic	
Consumer Price Inflation	3 year average (centred on current year) of annual change in consumer price index (CPI). The forecast at time t rather than the actual outturn is used, signified by 'HF'.
Real GDP Growth	3 year average (centred on current year) of annual change in real GDP. The forecast at time t rather than the actual outturn is used, signified by 'HF'.
Real GDP Growth Volatility	Natural log of the trailing 10 year standard deviation of average annual change in real GDP.
Public Finances (General Government)	
Budget Balance	3 year average (centred on current year) of general government (budget) balance (GGB) as a percent of GDP. The forecast at time t rather than the actual outturn is used, signified by 'HF'.
Gross Debt	3 year average (centred on current year) of gross (general) government debt (GGD) as a percent of GDP. The forecast at time t rather than the actual outturn is used, signified by 'HF'.
Interest Payments	3 year average (centred on current year) of gross government interest payments (GGI) as a share of general government revenues (REV).
Public Foreign Currency Debt	3 year average (centred on current year) of public foreign currency denominated (and indexed) debt (PFCD) as a share of gross (general) government debt (GGD).
External Finances	
Commodity Dependence	Non-manufactured merchandise exports as a share of current account receipts (CXR).
Current Account Balance plus net Foreign Direct Investment	3 year average (centred on current year) of current account balance (CAB) plus net foreign direct investment (FDI) as a percent of GDP.
Gross Sovereign External Debt	3 year average (centred on current year) of gross sovereign external debt (GPXD) as a share of gross external debt (GXD).
External Interest Service	3 year average (centred on current year) of external interest service expressed as a share of current external reciepts (CXR).
Official International Reserves	Year-end stock of international reserves (including gold) expressed as months' cover of import payments (CXP).
Structural	
Financial Market Depth	Natural log of financial assets (sum of the outstanding stock of public and private sector debt securities, market capitalisation of the domestic stock market, private sector credit and official international reserves) relative to GDP.
GDP per Capita	Percentile rank of GDP per capita in US dollars at market exchange rates.
Composite Governance Indicator	Average percentile rank of World Bank governance indicators: 'Rule of Law'; 'Government Effectiveness'; 'Control of Corruption'; 'Voice & Accountability' and 'Political Stability'.
Reserve Currency Status	Reserve currency status: 3 = 'strong'; 2 = 'medium'; 1 = 'low'; 0 = none.
Years since default	Non-linear function of the time since the last default (since 1980); the indicator is zero if there has been no default. For each year that elapses, the impact on the model output declines.

Figure 5. *Sovereign Rating Model – Key variables*

Fitch has developed a proprietary Sovereign Rating Model (SRM) that generates on the basis of the variables described in the above figure a score calibrated to the Long-Term Foreign-

[181] A number of other 'Master Criteria' documents were also issued in August 2010, available from: http://www.businesswire.com/news/home/20100813005704/en/Fitch-Publishes-Updates-Global-Master-Criteria. See Fitch Ratings, Sovereign Rating Methodology. Master Criteria, 15 August 2011, available from: http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648978.

Currency IDR. However, the outcome of the SRM is treated as only one of a range of qualitative and quantitative inputs into the rating process. The actual rating determined by the sovereign rating committee can and does differ from that implied by the rating model.

ANNEX VI. PROBLEM DEFINITION – BACKGROUND AND TECHNICAL DETAILS

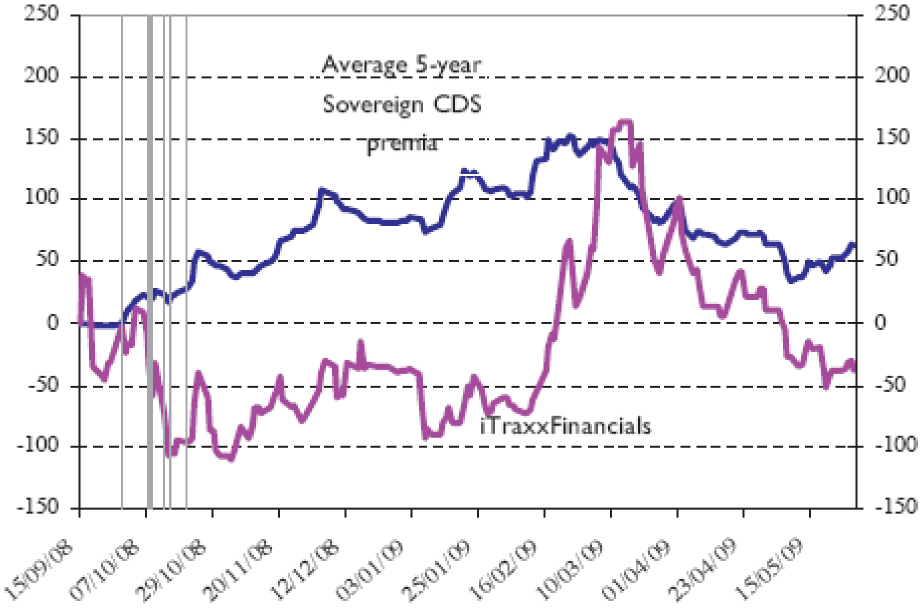
1 – Background on the Financial Crisis

Since August 2007 financial markets worldwide are suffering from a major confidence crisis. The crisis originated in the US residential subprime mortgage market and subsequently developed into other sectors of the financial markets.

This subprime turmoil hit Europe through three different channels. Firstly, some EU financial institutions faced losses because they were exposed to the US sub-prime market. Secondly, the US sub-prime problems have considerably slowed down US growth prospects. Given global trade inter-linkages this affects the EU economic growth as well. Thirdly, the general market uncertainty eroded equity market prices also in Europe as well as reduced consumer and business confidence.

CRAs were close to the origin of the problems that have arisen with subprime markets: they were giving favourable opinions on instruments that were financially engineered to give high confidence to investors. The investors – relying on CRAs' expertise – very often took little or no interest in the risks characteristics of these instruments, performance of underlying assets and general market outlook.

CRAs failed to reflect early enough in their ratings the worsening of market conditions. The explanation for this poor performance by CRAs could be found in the unsatisfactory way the agencies manage their conflicts of interest, the lack of quality of the ratings they issued, the need for improved transparency of the agencies and the inappropriate internal governance. The subprime debacle demonstrated that the existing framework for the operation of CRAs needs to be significantly reinforced.



Sources: Datastream and ECB staff calculations.
Note: The vertical bars indicate the dates on which bank rescue packages were announced in euro area countries.

Figure 1. *Cumulative changes in average five-years sovereign CDS premia for euro area countries and iTraxx financial index[182] (15 September 2008- 25 March 2009; bps)*

The analysis of the announcements and downgrades from 3 large rating agencies (S&P, Moody's and Fitch) in the period from October 2006 until August 2010 covers the financial crisis and the consequent Euro debt crisis. In this period, 46 rating announcement of EU Member States have been observed, of which there were 30 rating changes (of which 29 downgrades and 1 upgrade), 13 outlook revisions, and one review for future downgrade.

Concurrent with the announcement of bank rescue packages in Euro-area countries, pressure on the financial sector eased while the opposite occurred at the general government level. This was felt though a sharp increase in sovereign credit default swap premiums for most EU countries, whereas the credit default swap premiums for European financial corporations reversed their upward trend and started to decline. Figure VI.1 illustrates these developments.

Appetite for risk on markets rapidly decreasing, markets for sovereign bonds started penalising more heavily the lack of absolute solidity in public finances of individual Euro-zone countries, as well as they started penalising other macroeconomic imbalances, in particular with respect to Germany.[183]

In this context, CRA intervened with some negative rating changes that surprised market, especially for the scale of the change.

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[182] iTraxx (Bloomberg code 'ITRX') is the brand name for the family of credit default swap index products covering regions of Europe, Australia, Japan and non-Japan Asia. They form a large sector of the overall credit derivative market. The indices are constructed on a set of rules with the overriding criterion being that of liquidity of the underlying Credit Default Swaps (CDS). The iTraxx suite of indices are owned, managed, compiled and published by International Index Company (IIC), who also license market makers.

[183] Attinasi M.G., Chcherita C., Nickel C. (2009), What explains the surge in Eurozone sovereign spreads during the financial crisis of 2007-09?, ECB Working Paper no. 1131/2009 and Archyrou M.G., Kontonikas A. (2011), The EMU sovereign-debt crisis: fundamentals, expectations and contagion, Economic Paper no. 436, European Commission.

Date	Country	Action	CRA
23/10/2006	Lithuania	Upgrade	Fitch
11/07/2008	Latvia	Downgrade	Moody's
11/07/2008	Hungary	Downgrade	Moody's
12/08/2008	Czech	Outlook	Moody's
27/10/2008	Romania	Downgrade	S&P
30/10/2008	Bulgaria	Downgrade	S&P
17/11/2008	Hungary	Downgrade	S&P
13/01/2009	Portugal	Outlook	S&P
14/01/2009	Greece	Downgrade	S&P
19/01/2009	Spain	Downgrade	S&P
21/01/2009	Portugal	Downgrade	S&P
07/02/2009	Ireland	Downgrade	Moody's
24/02/2009	Estonia	Downgrade	S&P
24/02/2009	Latvia	Downgrade	S&P
24/02/2009	Lithuania	Downgrade	S&P
25/02/2009	Greece	Outlook	Moody's
21/03/2009	Hungary	Downgrade	Moody's
27/03/2009	Slovakia	Outlook	Moody's
30/03/2009	Hungary	Downgrade	S&P
11/04/2009	Ireland	Downgrade	Fitch
23/04/2009	Latvia	Downgrade	Moody's
23/04/2009	Lithuania	Downgrade	Moody's
04/08/2009	Estonia	Downgrade	Fitch
06/08/2009	Ireland	Downgrade	S&P
12/08/2009	Greece	Downgrade	Fitch
01/09/2009	Ireland	Outlook	S&P
03/09/2009	Spanish	Maintain	Moody's
12/09/2009	Spain	Outlook	S&P
29/10/2009	Portugal	Outlook	Moody's
01/12/2009	Spain	Outlook	S&P
16/12/2009	Greece	Downgrade	S&P
22/12/2009	Greece	Downgrade	Moody's
21/01/2010	Bulgaria	Outlook	Moody's
24/03/2010	Portugal	Downgrade	Fitch
31/03/2010	Lithuania	Outlook	Moody's
31/03/2010	Latvia	Outlook	Moody's
31/03/2010	Estonia	Outlook	Moody's
22/04/2010	Greece	Downgrade	Moody's
27/04/2010	Greece	Downgrade	S&P
27/04/2010	Portugal	Downgrade	S&P
28/04/2010	Spain	Downgrade	S&P
05/05/2010	Portugal	Review	Moody's
04/08/2010	Latvia	Downgrade	Fitch
04/08/2010	Lithuania	Downgrade	Fitch

Figure 2. *Overview of sovereign rating announcements of EU Member States*[184]

	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2009:Q	2009:Q	2009:Q3	2009:Q4	2010:Q	2010:Q	2010:Q	2010:Q4
EU Up	0	0	0	0	0	0	0	0	0	0	0	0
EU No change	0	0	1	0	3	0	3	2	4	1	0	0
EU Down	0	0	-2	-3	-9	-3	-3	-2	-1	-4	-1	0

Figure 3. *Upgrades/Downgrades for Sovereign Debt ratings of EU Member States by the 3 largest credit rating agencies*[185]

According to the IMF[186], while downgrades were somehow expected by markets, their extent - as they sometimes involved several notches at the same time - surprised markets.

In most cases rating changes arrived after already substantial movement in government bond spreads. Very few announcements were in fact before the third quarter of 2008. It appears therefore that the 3 main rating agencies have not sufficiently anticipated the macroeconomic

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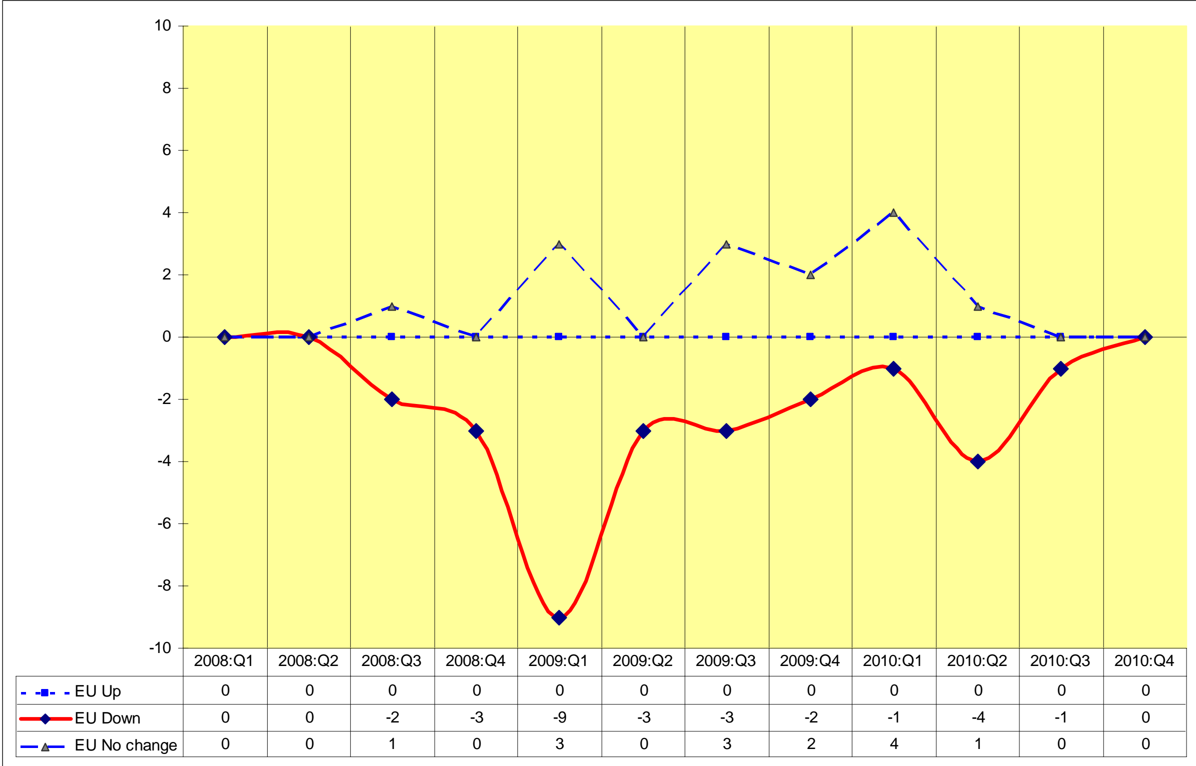
[184] IMF working paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis. Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis, March 2011, WP/11/68.

[185] European Commission, analysis based on data from IMF working paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis?

[186] IMF, Global Financial Stability Report, Chapter 3, The uses and abuses of Sovereign Debt Ratings, October 2010, p. 88.

weaknesses of European economies consecutive to the financial crisis [187] and, that they have been slow in reacting to the changing economic situations in some Member States. A shown in Figure 4, the pick of negative announcements was reached in the first Quarter of 2009. The number of negative rating announcements afterwards decreased but continued and reached a further "peak" of downgrades the second quarter of 2010 when the European Financial Stability Facility (EFSF) was adopted.



	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2010:Q2	2010:Q3	2010:Q4
EU Up	0	0	0	0	0	0	0	0	0	0	0	0
EU Down	0	0	-2	-3	-9	-3	-3	-2	-1	-4	-1	0
EU No change	0	0	1	0	3	0	3	2	4	1	0	0

Figure 4. *Sovereign Debt Ratings - Upgrades/Downgrades of EU Member States by the 3 largest credit rating agencies*

This Euro-zone debt crisis was not the first time that CRA seemed to react to events rather than anticipating them. It was already the case during the Mexican Crisis of 1994-95, and during the Asian Crisis of 1997. Also in those cases CRA were accused of both being too slow initially in downgrades, and subsequently of downgrading more than the worsening fundamentals justified.[188]

As ratings actually influence markets[189], their inaccuracy and/or ill timing creates concerns for financial stability.

[187] Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis, March 2011, WP/11/68.

[188] See IMF (1999), International Capital Markets, and Ferri G., Liu L., and Stiglitz J. (1999), the Procyclical role of Rating Agencies: Evidence from the East Asia Crisis, Economic Notes, 28-3.

[189] See Arezki R., Candelon B., Sy, A. (2011), Sovereign rating News and Financial markets Spillovers: Evidence from the European Debt Crisis, IMF Working Paper 11/68

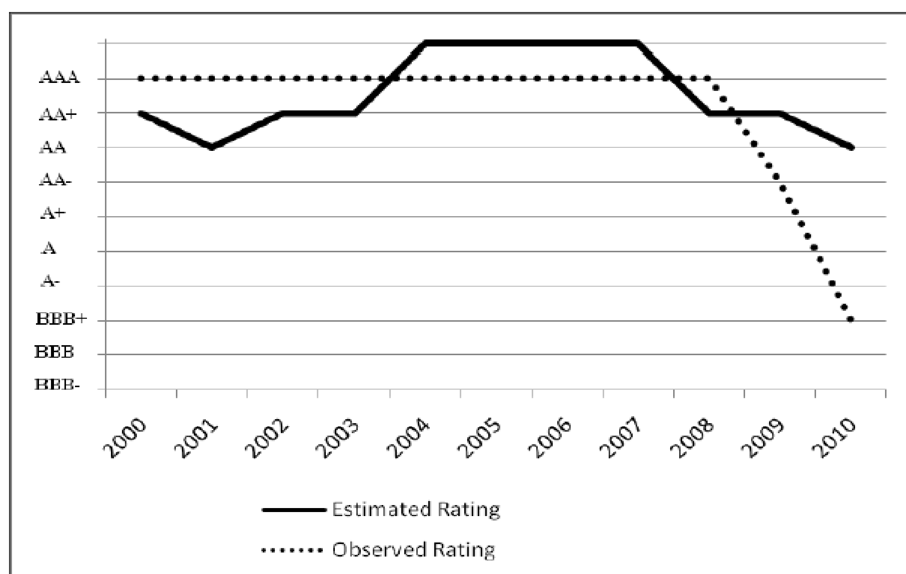


Figure 5. *Ireland's observed and predicted ratings according to Regression (I)*[190]

Regarding ill-timing, if sovereign ratings lag rather than lead financial markets, improving ratings tend to reinforce euphoric expectations and stimulate excessive speculation during the booming periods, while during the bust, downgrading can spread panic among investors, driving money excessively out of markets.[191] A good example of this lagging behaviour from CRA can be resumed from recent academic works.[192] Figure 5 shows for example how, for the case of Ireland, ratings seems to have been changed in the beginning too late compared to macro-economic fundamentals, and then too much once again compared to what justifiable on the basis of macroeconomic variables.

Regarding inaccuracy, first of all CRA cannot easily acquire superior information on sovereigns. Second, there are reasons to consider that cardinal accuracy of ratings, i.e. their relationship with reference probability of defaults, important. However, it should be noted that while banks are subject to rigorous calibration tests of their internal ratings, CRAs are normally not even transparent about they calibrate and about how they validate ratings to default risk metrics. [193]

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190 A regression line known as a "line of best fit".

191 Reisen H., von Maltzan J. (1999), Boom and Bust and Sovereign Ratings, International Finance, 2(2).

192 Gärtner M., Griesbach B., Jung F. (2011), PIGS or Lambs? The European Sovereign Debt Crisis and the Role of rating Agencies, University of St. Gallen, Discussion Paper 2011-06.

193 On how ratings cardinal accuracy can be validated on the basis of statistical text, see Coppens F., Gonzalez F., Winkler G. (2007), The performance of credit rating systems in the assessment of collateral used in Eurosystem Monetary Policy operations, ECB Occasional Paper n. 65, and De Lisa R., Marchesi M., Zedda S. (2009), Thresholds for Ratings' Forecast Default Probabilities: Some Quantitative Evidences in "New Frontiers in insurance and risk management", McGraw-Hill, Milano.

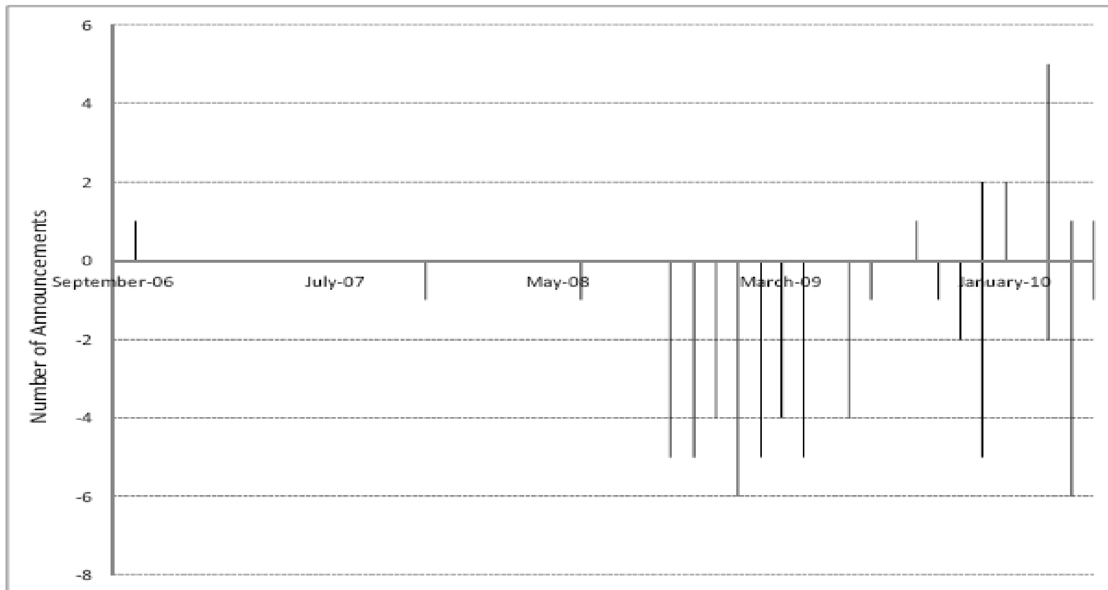

Figure 6. *Positive and negative announcements over time (from 09/2006 to 01/2010)*

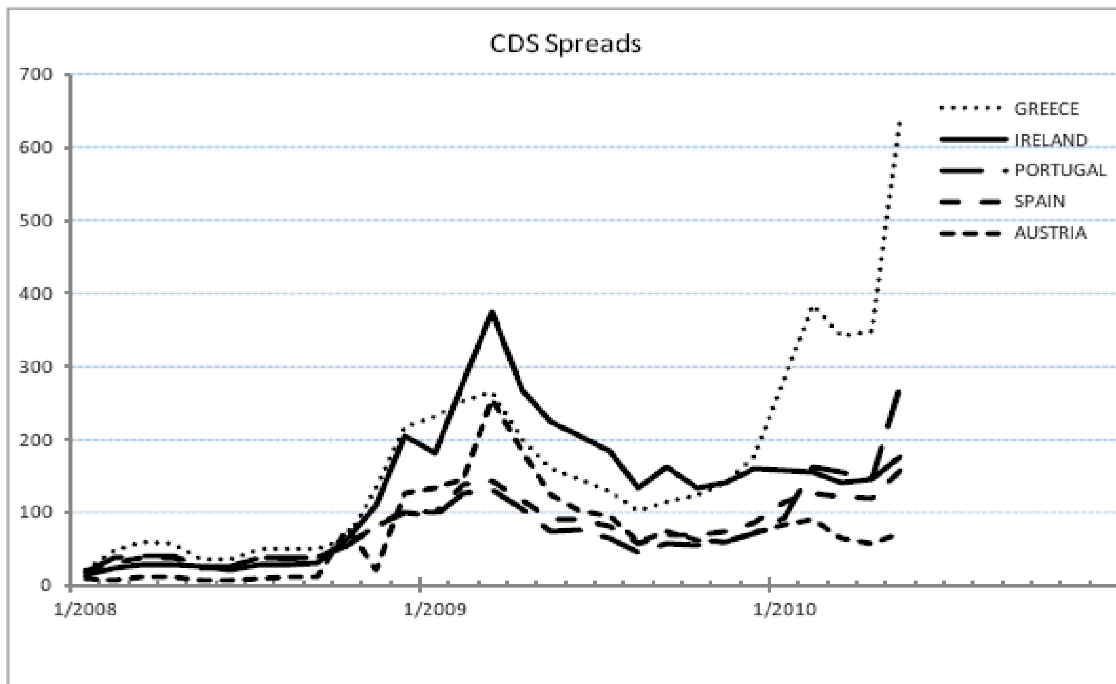

Figure 7. *CDS Spreads for Selected European Countries and Greece Credit Ratings (from 01/2008 to 01/2010)*

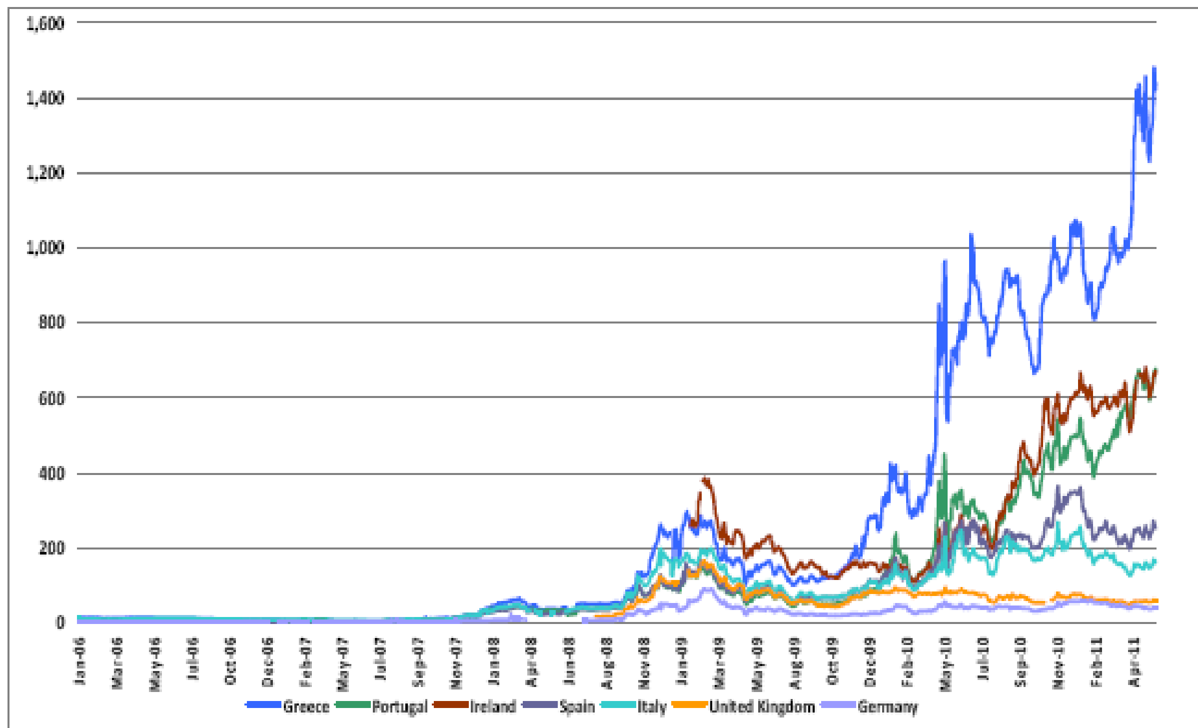

Figure 8. *Comparison of European sovereign spreads (bp) (from 01/2006 to 04/2011)*[194]

The recent financial and economic crisis had put a heavy burden on public finances in euro area countries and other EU Member States. [195] It resulted a heavy burden on taxpayers that may have to come to the rescue of a failing systemic relevant institutions.

The main factors that have contributed are (1) In some countries large fiscal costs are related to capital injections for financial institutions; (2) The economic downturn had an immediate impact on tax receipts and unemployment-related spending; (3) The discretionary measures adopted to compensate for declining private demand in the economy had an adverse impact on fiscal positions.

The ECB has reported[196] that over the last three years, governments have taken various measures to strengthen the financial system and reduce the systemic risks in the financial sector which emerged in the context of the global financial crisis. The direct costs are recorded in government debt (e.g. capital injections for banks for which the government had to borrow in the market) and the recovery of these costs will depend on the future value of the acquired bank assets.

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[194] Source Bloomberg.

[195] For an overview, see van Riet, A. (ed.), "Euro area fiscal policies and the crisis", Occasional Paper Series, No 109, ECB, Frankfurt am Main, April 2010.

[196] Monthly Bulletin April 2011, European Central Bank, Eurosystem, p. 69.

(as a percentage of GDP)

	Measures with an impact on government debt				Measures with an impact on government contingent liabilities	
	Capital injections	Other measures	Total impact on government debt	*o/w redemptions*	Total contingent liabilities	Ceilling
Belgium	5.7	0.1	5.8	*2.0*	15.9	27.8
Germany	2.0	10.7	12.7	*0.0*	8.1	17.7
Estonia	0.0	0.0	0.0	*0.0*	0.0	0.0
Ireland	10.0	13.5	23.5	*0.0*	97.6	97.6
Greece	1.6	0.6	2.3	*0.0*	16.3	27.2
Spain	0.1	2.0	2.1	*0.0*	5.3	19.0
France	0.2	0.0	0.2	*0.4*	5.1	24.4
Italy	0.3	0.0	0.3	*0.0*	0.0	0.0
Cyprus	0.0	0.0	0.0	*0.0*	17.2	17.2
Luxembourg	6.2	0.0	6.2	*0.2*	0.0	0.0
Malta	0.0	0.0	0.0	*0.0*	0.0	0.0
Netherlands	7.2	2.4	9.6	*8.9*	6.7	34.1
Austria	2.2	0.1	2.2	*0.0*	8.2	18.3
Portugal	0.0	0.0	0.0	*0.0*	4.6	11.7
Slovenia	0.0	4.0	4.0	*0.0*	6.1	33.5
Slovakia	0.0	0.0	0.0	*0.0*	0.0	0.0
Finland	0.0	0.0	0.0	*0.0*	0.0	0.0
Euro area	**1.6**	**3.6**	**5.2**	**0.7**	**7.4**	**19.1**

Source: ESCB.
Notes: The cut-off date was end-February 2011. Contingent liabilities on retail bank deposits are not included.

Figure 9. *Cumulated financial sector stabilisation operations and their impact on government debt and contingent liabilities (2008-10)*[197]

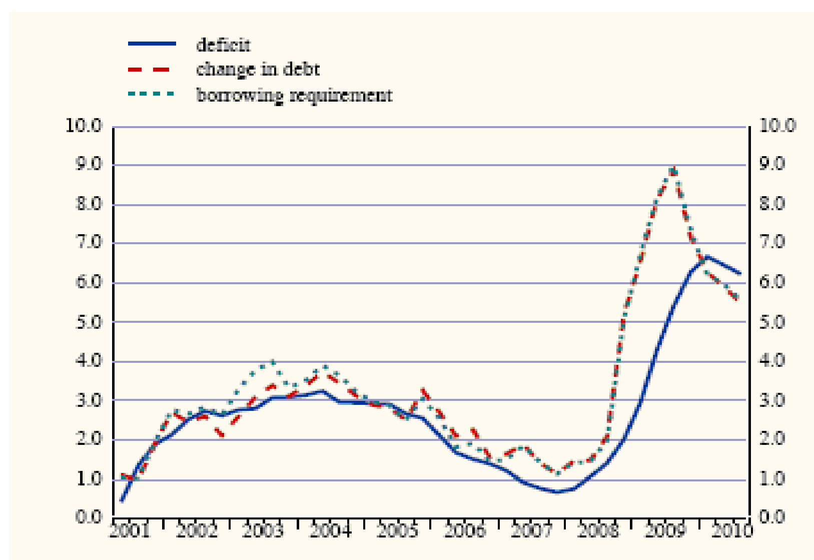

Figure 10. *Deficit, borrowing requirement*[198] *and change in debt (four-quarter moving sum as a percentage of GDP)*[199]

2 – Description and Analysis of Problem Drivers and Problems

2.1 References to ratings in EU Financial Regulation

Banking

The Capital Requirements Directive (CRD)[200] requires credit institutions to have their own sound credit granting criteria and credit decision processes in place. [201] This applies

[197] Monthly Bulletin April 2011, European Central Bank, Eurosystem, p. 70.

[198] Borrowing requirement (general government): net incurrence of debt by the general government.

[199] Sources: ECB calculations based on Eurostat and national data. For an overview, see Monthly Bulletin April 2011, European Central Bank, Eurosystem, p. 151.

[200] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177/1, 30.6.2006).

irrespective of whether institutions grant loans to customers or whether they incur securitisation exposures. Basing credit decisions solely on external credit rating agency ratings does not fulfil this requirement under EU-banking legislation.

For the specific purposes of calculating regulatory bank capital requirements, rating agency assessments are, in certain instances, applied as a basis for differentiating capital requirements according to risks[202], and not for determining the minimum required quantum of capital itself. The CRD framework as a whole provides banks with an incentive to use internal rather than external credit ratings even for purposes of calculating regulatory capital requirements.[203] In the specific case of securitisation exposures and due to a lack of sufficiently objective internal methodologies within banks, most of them would be expected to calculate their regulatory capital requirements by reference to external ratings.[204]

Insurance and reinsurance

The existing directives on the supervision of insurance and reinsurance undertakings do not contain any provisions which place reliance on credit rating agencies. There is actually no credit risk charge for the solvency margin in the existing framework of insurance and reinsurance directives ("Solvency I").[205] However, "Solvency I" is a minimum harmonisation and a number of Member States' national laws implementing the investment and capital requirement rules of the current "Solvency I" Directives[206] do refer to ratings.[207]

The "Solvency II" Framework Directive[208], which introduces risk-oriented solvency requirements for insurance and reinsurance undertakings, addresses credit risk but it does not contain any provisions referring to or placing reliance on credit rating agencies. Capital requirements are calculated using a standard formula or, subject to supervisory approval, by the undertaking's internal model.[209] The precise design of the standard formula capital requirements, including the market risk[210] and counterparty default risk capital charge, will be set out in the future level 2 implementing measures which are currently being developed. In the fifth Quantitative Impact Study (QIS5)[211], which is currently being carried out, credit

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201 Annex V point 3 of Directive 2006/48/EC.

202 This concerns the "Standardized Approach" (Art. 78 ff Directive 2006/48/EC) and Securitizations (Art. 94, 96 Directive 2006/48/EC).

203 Articles 78 and 84 in connection with Annex VII of Directive 2006/48/EC.

204 Articles 94, 96 Directive 2006/48/EC.

205 See provisions on the solvency margin: Articles 27 to 31 of Directive 2002/83/EC, Article 1 of Directive 2002/13/EC of 5 March 2002, OJ L 77, 20.3.2002, and Articles 37 to 39 of Directive 2005/68/EC of 16 November 2005, OJ L 232, 9.12.2005.

206 Articles 22 to 26 of Directive 2002/83/EC and Articles 20 to 23 of Directive 92/49/EEC.

207 For example, in the Netherlands, De Nederlandsche Bank publishes credit spreads that (smaller) pension funds can use when they cannot obtain market data to determine buffers to cover against reinsurance defaults. In the United Kingdom, the Insurance Prudential Sourcebook 1.6 provides a table with “listed rating agencies” Credit ratings from these firms are used in determining assumed spread stresses. Ratings are also used in the German insurance sector for asset identification as one possible criterion to determine the safety of the asset.

208 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) , OJ L 335, 17.12.2009.

209 Articles 100 to 127 of Directive 2009/138/EC.

210 Market risk is caused by the day to day fluctuation in assets or securities prices which could be resulted in loss or profit. This risk is common to an entire class of assets and liabilities. Since this risk is caused by market itself it can not be diversified away. For instance changes in exchange rate, interest rate fall under this risk. Also a natural disaster which can have great impact on the prices of assets and securities are known as market risk. For the banking sector Basel II has proposed two main approaches to calculate this risk: standardized approach and model approach.

211 In order to assess its impact the development of "Solvency II" is accompanied by five Quantitative Impact Studies. In these studies insurance and reinsurance undertakings as well as insurance groups

ratings are used in the calculation of the standard formula, but QIS5 technical specifications do not prejudge any final decision as regards the standard formula.

Pensions

The Institutions for occupational retirement provision (IORP) Directive[212] does not contain any provisions referring or placing reliance on credit rating agencies. A few Members States' rules and supervisory practices regarding IORPs do make use of credit ratings, for example with respect to investment rules and determination of an appropriate discount rate.

Investment funds (UCITS)

There is no reference to credit ratings in the UCITS directive 2009/65/EC.[213] It does not provide for an obligation to take into account external credit ratings in the investment decision making process.

Money market funds

There are no references to external ratings in the UCITS directive with respect to money market funds. However, the CESR Guidelines on money market funds[214] contains references to external ratings. According to this guideline, when assessing the quality of a money market instrument, a management company must consider the credit quality of that instrument. For this purpose a money market instrument is not considered to be of high quality unless it has been awarded one of the two highest available short-term credit ratings by each recognised CRA that has rated the instrument or, if the instrument is not rated, it is of equivalent quality as determined by the management company's internal rating process. However, the guideline clarifies that the responsibility for the assessment of the quality of a money market instrument lies with the management company. In making such assessment it should take into account a range of factors and should not place undue weight on the credit rating of the instrument. Money market funds may hold sovereign issuances of at least investment grade as awarded by one or more recognised CRAs.

Investment firms

For the purposes of defining high quality money market instruments that must be held by qualifying money market funds (which are allowed – at par with credit institutions and other eligible entities – to receive on a temporary basis clients funds from an investment firm), Article 18 of Directive 2006/73/EC (the MiFID Implementing Directive)[215] makes reference to ratings of these instruments issued by competent CRAs.[216] It requires that these instruments should have been awarded the highest available credit rating by each competent rating agency

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under the scope of "Solvency II" determine their eligible own funds and capital requirements according to preliminary specifications of the new rules.

212 Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235/10, 23.9.2003.

213 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302/32, 17.11.2009.

214 CESR's guidelines on a common definition of European money market funds of 19 May 2010, CESR/10-049. These guidelines are not legally binding but national regulators will be expected to implement them.

215 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006).

216 According to the same article, a rating agency shall be considered to be competent if it issues credit ratings in respect of money market funds regularly and on a professional basis and is an eligible external credit assessment institution (ECAI) within the meaning of Article 81(1) of Directive 2006/48/EC.

which has rated that instrument. An instrument that is not rated by any competent rating agency shall not be considered to be of high quality.

Disclosure requirements for securities

When securities are offered to the public or admitted to trading on a regulated market according to the Prospectus Directive[217] a prospectus needs to be published. On debt issues for instance Annex V paragraph 7.5 of the Prospectus Implementing Regulation[218] requires that the prospectus must contain information on credit ratings – if available – assigned to an issuer or its debt securities at the request or with the cooperation of the issuer in the rating process including a brief explanation of the meaning of the ratings if this has previously been published by the rating agency.

ECB Regulation

The Eurosystem credit assessment framework (ECAF) defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met.[219]

In the assessment of the credit standard of eligible assets, the Eurosystem takes into account credit assessment information from credit assessment systems belonging to one of four sources, namely:

- external credit assessment institutions (ECAIs),
- NCBs' in-house credit assessment systems (ICASs),
- counterparties' internal ratings-based (IRB) systems, or
- third-party providers' rating tools (RTs).

Additionally, in the assessment of the credit standard the Eurosystem takes into account institutional criteria and features guaranteeing similar protection for the instrument holder such as guarantees.

The Eurosystem's normal benchmark for establishing its minimum requirements for credit quality threshold is defined in terms of a "single A" credit assessment—corresponding to a probably of default (PD) over a one-year horizon of up to 0.10 percent. In October 2008, the credit quality threshold was temporarily relaxed and allowed to admit up to triple-B collateral—with a PD equal to 0.40 percent. In April 2010 the Governing Council of the ECB decided to prolong the use of that category of assets beyond the end of 2010. The new eligible instruments need to be monitored against the credit quality thresholds.

European Financial Stability Facility Framework Agreement

The establishment of the European Financial Stability Facility (EFSF)[220] framework agreement[221] of 7 June 2010 between the EFSF and the "euro-area Member States" or "EFSF Shareholders" sets out detailed operating conditions of the EFSF that contain references to

[217] Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345/64, 31.3.2003).

[218] Regulation (EC) No 809/2004 implementing Directive 2003/71/EC (OJ L 215/3, 16.6.2004).

[219] The general documentation on the ECAF is in Section 6.3 of the General Documentation, Section 6.3, as well as the amendments set out in Guideline ECB/2009/01, available from: http://www.ecb.int/paym/coll/elisss/html/index.en.html.

[220] The EFSF is a "société anonyme" incorporated in Luxembourg.

[221] European Financial Stability Facility (EFSF) framework agreement available from: http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf.

external ratings[222]. The European Financial Stability Mechanism will be replaced by a new instrument as of 2013, the European Stability Mechanism (ESM). The treaty establishing[223] the ESM does not contain any direct references to external ratings.

State Aid

Credit ratings are currently used by the Commission in assessing measures adopted by Member States under the State aid Rules in different contexts.

First, the Communication from the Commission on the revision of the method for setting the reference and discount rates and the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees[224] uses an entity's credit rating (but not limited to external rating) to establish whether state guarantees or loans constitute State aid.[225]

Second, in the context of the pricing of state guarantees for banks, since July 2010, a step-up fee (in addition to the level recommended by the ECB) is applied and depends on the bank's credit rating.

Third, in assessing whether state guarantees are being appropriately priced pursuant to the Communication from the Commission on the Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis[226], the Commission will use a bank's credit rating as a measure of its creditworthiness.

Fourth, the current rating and the outlook of a financial institution is one of the four criteria set out in Annex I of the Commission Communication on Recapitalisation of Financial Institutions of 5 December 2008[227] for evaluating whether a bank can be classified as sound or distressed. However, this Communication is currently being revised and as such, this requirement may be removed from the rules applicable from January 2011 onwards.

Finally, the Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector of 25 February 2009[228] requires banks to disclose the current rating (when available) for each basket of activities they hold, such as structured products and securitised positions. This information is used as complementary source of information to the assessment of the impaired assets which are to be transferred to or guaranteed by a Member State, but is not the primary benchmark for the valuation of such impaired assets. In this respect, a detailed and independent look-through analysis is performed to calculate expected losses and when relevant, confronted with the results deriving from external credit ratings.

2.2 – Sovereign Debt Ratings

Definition of Sovereign Ratings and Sovereign Default

Sovereign credit ratings can be defined as a condensed assessment by credit rating agencies of a government's ability and willingness to repay its public debt both in principal and in

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222 More particularly, point 2 (3) regarding issues of guarantees states that the EFSF may also request the Guarantors to issue Guarantees under this Agreement for other purposes which are closely-linked to an issue of Funding Instruments and which facilitates the obtaining and maintenance of a high quality rating for Funding Instruments issued by EFSF and efficient funding by EFSF

223 Treaty establishing the European Stability Mechanism (ESM) signed on 11 July 2011, currently under ratification by the Eurozone Member States. http://www.efsf.europa.eu/attachments/esm_treaty_en.pdf

224 OJ C 155, 20.6.2008, p. 10–22. With effect from 1 December 2009, Articles 87 and 88 of the EC Treaty have become respectively Articles 107 and 108 of the TFEU. The two sets of provisions are in substance identical.

225 OJ C 14, 19.1.2008, p. 6–9.

226 OJ C 270, 25.10.2008, p.8.

227 OJ C 10, 15.1.2009, p. 2-10.

228 OJ C 72, 26.03.2009, pages 1-22.

interests on time. In this, context, they are considered forward-looking qualitative measures of the probability of default put forward by rating agencies.[229]

A sovereign defaults when it fails to make timely payment of principal or interest on its debt, or if it offers a distressed exchange for the original debt[230]. According to the IMF, default events do not usually include the failure to repay debt owed to other governments and official creditors, including the IMF and World Bank.

However, definition of default risk varies among the main rating agencies. S&P measures default risk in terms of default probability whereas Moody's ratings measure expected loss. Fitch rates issuers on a default probability basis and instruments on an expected loss basis. As a result, at least in theory, Moody's ratings should diverge from Fitch's and S&P's on the same issuer according to variations in loss severity. According to the IMF, in practice, little divergence is observed, particularly among investment-grade ratings.[231]

CRAs typically signal in advance their intention to consider rating changes[232]. For example, Fitch, Moody's, and S&P all use negative "review" or "watch" notifications to indicate that a downgrade is likely within the next 90 days. They use a negative "outlook" notification to indicate the potential for a downgrade within the next two years (one year in the case of speculative-grade credits).

Importance of Sovereign Debt Ratings

Sovereign credit ratings are considered important for at least three reasons. First, sovereign ratings are a key determinant of a country's borrowing costs in international capital markets. In this context sovereign ratings affect countries access and the terms of that access to capital markets, with the threshold between investment-grade and speculative-grade ratings having important market implications.[233]

Second, according to a recent study, the sovereign rating generally sets a ceiling for the ratings assigned to domestic banks and companies[234], and therefore affects private financing costs. Therefore, sovereign ratings affects not only financing costs for the sovereign but also corporates and credit institutions with international capital market access are constrained by the sovereign ratings. In this context, it should be noted that there exists a direct link between sovereign ratings and ratings of financial institutions located within the territory of the sovereign.

Third, some institutional investors have lower bounds for the risk they can assume in their investments and will choose their portfolio composition taking into account the credit risk signalled by the rating notations. Therefore, according to a recent study, sovereign ratings" also expands the pool of potential buyers of a country's bond issuances to institutional investors[235].

Sovereign debt –Sources of spillover effects

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[229] Afonso, A., P. Gomes, and P. Rother (2007), What 'Hides' Behind Sovereign credit Ratings? ECB Working Paper No. 711.

[230] IMF, Financial Stability Report, 2010, chapter 3: the uses and abuses of sovereign ratings.

[231] Ibid.

[232] Ibid.

[233] Jaramillo L., Determinants of Investment Grade Status in Emerging Markets, IMF working paper, 2010. reference WP/10/117.same comment as above –reduce the number of footnoes

[234] Ibid.

[235] Ibid.

A recent study[236] has demonstrated that sovereign downgrades have statistically and economically significant spillover effects both across countries and financial markets. According to the study, there are many potential channels through which sovereign rating news may have spillover effect across countries and across financial markets. Another recent study[237] has shown that there's asymmetry in market reactions to sovereign debt rating changes, i.e. while there is a significant reaction of sovereign yield spreads (and particularly CDS spreads) to negative events, the reaction to positive events is much more muted.

In this context, a sovereign rating downgrade in a given country is likely to affect the profitability of domestic banks of the country and of banks in other countries where banks are holding this debt. This is the case of Europe where banks hold at times substantial amount of sovereign debt in both their trading and banking books.[238]

Sovereign rating news may spill over across countries and markets when banks across countries hold claims on banks in other countries and are thus exposed to one another. As this cross-holding feature is an important element of the European financial markets sovereign credit rating announcements may spillover to other markets as a result of rating-based triggers such as those in banking regulation, ECB collateral rules, CDS contracts or investment mandates.

According to the study, sovereign rating downgrades have statistically and economically significant spillover effects both across countries and financial markets implying that rating agencies announcements could spur financial instability. Those spillover effects depend both on the type of rating announcements, on the source country experiencing the downgrade and the rating agency from which the announcements originates from. Furthermore, the study found evidence that some rating announcements such as rating downgrades near speculative grade (for example, the. downgrade of Greece to BBB+ from A- by Fitch on December 8, 2009) have a systematic spillover effects across Euro zone countries under consideration (For example, it resulted in a 17 and 5 basis points increase respectively for Greek and Irish CDS spreads). Another example of spillover effects is the Austrian CDS spreads and stock market indices moved which sharply following the downgrades of Baltic countries, while the Austrian credit rating remained unchanged. One possible channel of this spillover effect is the exposure of Austrian banks to the Baltic countries.

Analysis of sector and cross-sector risks related to sovereign ratings

According to the Cross-Sectoral Risk Task Force[239] (hereafter referred to as the CSR TF) of the three European Supervisory Authorities (ESAs), there has been a visible link between sovereign and bank CDS spreads multiple countries , including GR, PT, IT as shown in chart 1 below. However, in the insurance sectors, such a correlation is less evident (as shown in 2 below). Contagion to other EU countries has been limited and mainly stems from cross-border holdings of government bonds and increased difficulty in issuing debt securities. So far, there

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236 Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis, March 2011, WP/11/68.

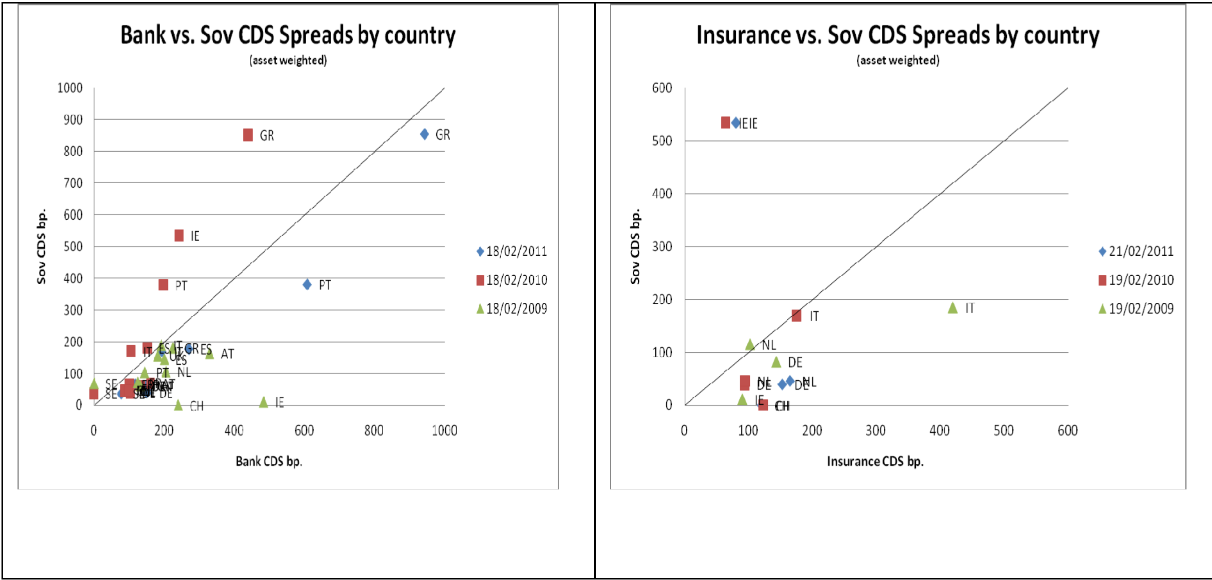
237 See Afonso, Furceri, Gomes, ECB paper n. 1347, June 2011. according to the Authors the reaction of CDS spreads to negative rating events has increased considerably after the beginning of the crisis (i.e. the 15.9.2008 – day of Lemahn bankruptcy).

238 Blundell-Wignall, A. and P. Slovik (2010), "The EU Stress Test and Sovereign Debt Exposures", OECD Working Papers on Finance, Insurance and Private Pensions, No. 4, OECD Financial Affairs Division. Available from: www.oecd.org/daf/fin.

239 Cross-Sectoral Risk Task Force of the European Supervisory Authorities: Cross-sectoral risk assessment report: March 2011. The report focuses on the common sources of risk for the different sectors of financial institutions and on cross-sectoral contagion links. The assessment of the risks is provided on the basis of the information collected in January 2011.

has not been evidence of destabilising speculation or market manipulation in the markets related to specific sovereign bonds.

The threats for the EU financial system involve, according to the CSR TF[240] , first, increased default risk premia for highly indebted countries propelling writedowns on all sovereign asset holdings that are marked-to-market. Second, the sovereign debt market unrest can spill-over to other markets such bank funding markets (increasing banks' funding costs) or equity markets as e.g. in May 2010, resulting in higher market risk levels for financial institutions. Third, the fiscal austerity measures, possibly aggravated by sovereign and bank funding problems, can contain economic growth and increase private sector credit risk.



Source: Internal study from BaFin, Germany

Figure 11. *Bank vs Sovereign CDS spreads by country and Insurance vs. Sovereign CDS spreads by country*

Sectorial risks due to Sovereign debt ratings

According to the CSR TF, the higher default risk premium of the affected countries and their rating downgrades also negatively affect the banks *domiciled in these countries*. These banks face higher funding costs irrespective of their own performance as their spreads and ratings are linked to those of the sovereign. Banks also hold large quantities of their own government debt, which has caused significant losses on market-value terms, and their credit risk outlook depends on the impact of the austerity measures on the real economy and asset prices, especially real estate.

Regarding the *rest of the EU banking sector*, according to the CSR TF, significant risk relates to the holdings of the sovereign debt of the affected countries. However, the most part of the exposure (on average around 80%) is held in the banking book. Banking book exposures are supposed to be held to maturity and are not marked-to-market.[241] While significant, most of the largest cross-border banking groups have relatively contained exposures to sovereign debt of countries other than their own domicile. Nevertheless, market concerns may spill over to other assets from the affected countries, like covered bonds.[242]

240 Ibid.

241 The EBA does not as yet have statistics regarding the proportion of assets allocated in the Available For Sale (AFS) portfolio of the banking book, for which market value losses are deducted from banks' own funds, unless own funds are insulated from market value changes through the use of "prudential filters".

242 EBA's assessment of sovereign debt risk will be repeated in the forthcoming stress test.

EU insurance undertakings and occupational pension funds manage a large government bond portfolio. For insurance undertakings the overall exposure towards government bonds of EEA countries (plus Japan, Switzerland and the U.S.) is roughly 1,300 bn EUR (24% of total assets) according to the data collected by European Insurance and Occupational Pensions Authority (EIOPA)[243]. The same figure for occupational pension funds is estimated around 350 bn EUR (14% of total assets). The impacts on specific undertakings depend on the extent of asset diversification. Generally, the portfolios are well-diversified.

In insurance and occupational pension sector there is *no evidence of fire sales,* but in some cases a partial shift towards more secured sovereign debt has taken place. In general, de-risking of the portfolios has taken place in the second and third quarters of 2010, according to the EIOPA survey.

In some EU countries, investment patterns of asset managers may be characterised by above-average exposures towards sovereign debt issued with "average plus" –yields, which could be an indication of the "search for yield" and greater risk taking.

Cross-sectorial and contagion risks due to sovereign debt ratings

According to the CSR TF, some banks followed by the European Banking Authority[244] (EBA) have already suffered from *consequences of the fiscal consolidation measures,* as reductions in disposable income has lead to an increase in loan loss provisions. In particular, the quality of the consumer loan portfolio has experienced a severe deterioration. Fiscal consolidation can reduce economic activity, leaving fewer growth and profit opportunities for all financial institutions, although it might also have longer-term beneficial effects, for example through improved confidence and lower funding costs.

According to the CSR TF, all EU banks could suffer from *contagion effects via funding markets* should the concerns related to sovereign risk persist. Also financial markets can more widely be affected by turmoil in sovereign debt markets, as was evidenced during 2010. The consequence can be hits in the pricing of assets and higher market volatility. This would in particular affect insurance undertakings and pension funds that have large investment portfolios.

According to the CSR TF, there is also close interaction between the sovereign and *municipal debt*. Municipal financing is a relatively important business for a number of major banks followed by the EBA. So far defaults on municipalities are rare, but the market pricing of municipal default risk is closely linked to that of the sovereign.

Risk description: Further negative developments in sovereign debt markets		
Sector affected	**Impact**	**Details**
Banking	High	Heightened liquidity and funding risks Decreased quality in loan portfolios Market value losses on sovereign debt instruments
Insurance	Medium to high	Market value losses on sovereign debt instruments
Financial conglomerates	Medium to high	
Asset management	Medium	Potential risks related to "search for yield"
Pension funds	Low	Market value losses on sovereign debt instruments
Consumers	High	Reduced public sector benefits and decreased

243 EIOPA is one of the three supervisory authorities responsible for the insurance sector, accessible at: https://eiopa.europa.eu/.

244 EBA is one of the three supervisory authorities responsible for the banking sector. More information is available at: https://eba.europa.eu/.

		private consumption
Cross-sector contagion issues	Risk of contagion to other financial markets (bank funding, equity, municipal debt) Reduced business activities due to fiscal consolidation	
Geographic impacts	Vary significantly per country - institutions in highly indebted countries most affected	
Policy implications	Supervisory attention towards institutions' sound risk management and adequacy of diversification Incentives are created to hold sovereign debt as prudential regulation in banking or insurance does not take into account increased sovereign risk premia	

2.3. Competition in the Credit Rating Sector

The root causes of the limited competition within the rating industry can be explained by market characteristics both on the demand side, which includes issuers and investors and supply side, which includes the credit rating agencies.

On the demand side, there is little willingness from issuers to pay for low or medium range ratings and many investors concentrate on securities rated by highly reputable agencies, channelling demand for ratings to a small number of CRAs.[245] This is related to the signalling function of ratings for issuers and the perceived informational quality and value of ratings to investors. Demand is also driven by "network effects", as ratings provide investors with a comparative risk evaluation.[246] More specifically, an important aspect of the value of a rating is its comparability to other ratings. Therefore, issuers favour ratings from leading rating agencies that can ensure the largest comparability of ratings for investors which increases market concentration.[247]

On the supply side, market concentration is reinforced by barriers to entry. Investors attribute considerable importance to reputation which is hard to acquire for new market entrants.[248] In this context, it should be noted that for a small rating agency with a low absolute number of ratings, even a single badly perceived rating could have a statistically relevant impact on its performance and reputation.

Furthermore, ratings from newly registered and authorised CRAs face restricted uptake by the market as they cannot always be used for regulatory capital purposes if they have not obtained the External Credit Rating Institute (ECAI) statute[249]. As shown in Annex IV, section 1, mainly 3 CRAs have obtained ECAI approval from the majority of national regulators while all other CRAs have obtained ECAI approval in only a very limited number of Member States,[250] thus limiting the choice for issuers and investors of CRAs whose ratings can be used for regulatory purposes.[251] Furthermore, due to the absence of a standardized rating scale,

[245] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, 2007, p59. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821.

[246] Financial instruments from diverse areas such as structured finance products or sovereign debt can be compared, whereas the "absolute risk" of the rating category can change over time, See BIS (Bank of International Settlements, Basel Committee on banking supervision, 2000: "Credit Rating and Complementary sources of credit Quality Information", Working Papers No 3, August 2000. Available from: http://www.bis.org/publ/bcbs_wp3.pdf.

[247] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, 2007, p73-74 Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821.

[248] OECD, Organisation for Economic Co-operation and Development, Credit Rating Agencies: Competition related issues, June 2010, DAF/COMP(2010)20, p.11.

[249] Article 1 of the CRA regulation states that registration is only a precondition to obtain ECAI statute under Directive 2006/48/EC.of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. A CRA needs to be ECAI to ensure that its ratings can be used for regulatory capital purpose as required in article 80-83 of Directive 2006/48/EC. Therefore, additional requirements provided for in Directive 2006/48/EC apply.

[250] All other CRAs have obtained ECAI approval in 6 or less Member States in July 2010.

[251] This is particularly relevant for issuers aiming to sell their debt instruments in an international context, requiring an ECAI statute in all Member States.

small CRAs' ratings are not always readily comparable. A further barrier to entry is that issuers and investors are sometimes unaware that alternative players exist.[252]

For investors, this implies that there is a strictly limited choice of ratings and limited alternatives available to compare ratings from a wide range of CRAs, while they have limited opportunity to assess rating quality. For issuers, market concentration implies limited choice and alternatives to be rated, and most probably, higher prices for ratings due to the oligopolistic structure of the market.[253] In addition, some segments of issuers, particularly Small and Medium-sized Enterprises (SMEs) or small sovereigns, might experience difficulty obtaining a rating as not all market segments are covered by rating agencies. For these enterprises ratings from existing rating agencies might be too expensive or these markets might be considered too small for existing rating agencies. This could be an additional barrier for Small and Medium-sized issuers to access capital markets. Furthermore, new entrants experience difficulty establishing themselves in the market and in gaining reputation. Evidence shows that those who are able to successfully establish themselves have often been taken over by existing rating agencies.[254]

It should be noted that the CRA regulation partially addresses this problem through registration and official endorsement.[255] Registration and official endorsement of new rating agencies under the CRA regulation is expected to improve the visibility of new rating agencies establishing themselves on the EU market. Furthermore, the high standards for rating methodology and the supervision of registered rating agencies are elements which could contribute to some extent to the reputation of newly established rating agencies among issuers and investors. Over a long period of time this could eventually contribute to diversity of rating agencies available on the EU market.

Some studies have argued that increased competition has reduced rating quality.[256] In this context, some authors believe that greater competition increases the risk of rating shopping and decreases reputation costs for CRAs, leading to inflated, lower quality ratings.[257] It should be noted that "increased" competition occurred in the market segment of structured finance products for which only a limited number of investment banks participated. CRAs' quality standards decreased as they raced to offer "better ratings" in order to retain business. This problem is addressed by the CRA Regulation, requiring high quality ratings and methodologies subject to regulatory supervision by ESMA.

2.4. Civil Liability

Survey of Member States' civil legal orders in respect of provisions on which investors could base claims against CRAs having infringed the CRA Regulation

The Commission services asked ESMA to survey a sample of Member States civil legal orders in respect of provisions on which investors could base claims against CRAs having infringed the CRA Regulation.

[252] European Association of credit rating agencies (ECRA), contribution to the public consultation of 7 January 2011.

[253] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, 2007, p100. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821.

[254] E.g. Fitch has established itself by an aggressive acquisition strategy, see Dodd, Randall ad Gautam Setty, 2003, "Credit Rating Agencies: Their Impact on Capital Flows to Developing Countries". Financial Policy Forum, Special policy report 6, 2003, p.7. Available from: http://www.financialpolicy.org/FPFSPR6.pdf.

[255] As provided for in Article 14-20 of the CRA Regulation.

[256] Becker, Milbourn, How did increased competition affect credit ratings? Harvard Business School, Working Paper 09-051, p.30.

[257] Camanho et al., 2010; Bolton et al., 2009; Skreta and Veldkamp, 2009.

All respondents said that investors could at least in theory base claims against CRAs having infringed the Regulation. The Member States did not in general have specific provisions relating to civil liability of CRAs. Only France adopted in 2010 a specific law in relation to the liability of CRAs not only to clients but also to third parties (including investors using ratings) "in case of delict and quasi-delict, for the harmful consequences of any negligence or breaches".

Investors without a contractual relationship with a CRA (which is the normal situation under the prevalent issuer-pays model) must refer to liability in tort, while a party with a contractual relationship can refer to contractual liability.

It seems that in many Member States it is not certain that an action based on liability in tort by an investor would be successful. In Sweden and Poland for example, it is rather unlikely that a party with no contractual relationship with a CRA could establish an indemnity liability claim under tort law. In other member states (UK, Netherlands) civil liability of a CRA vis-à-vis investors depends on a range of criteria and courts take a flexible approach depending on the circumstances of the case. In Germany, civil liability vis-à-vis investors that do not have a contractual relationship with the CRA could theoretically be based on delict (Art. 823 (2) of Bürgerliches Gesetzbuch (German civil code), however this requires that courts consider that the specific provision of the CRA Regulation that has been infringed intends to protect the investors and it is not clear whether courts will actually make this assumption.

Also notable was the various degrees to which civil liability could be excluded or limited under the different legal orders; again varying from state to state. There was a common need to establish a causal link leading to the damages, and most Member States had a standard of fault of negligence and intention.

The following summary contains assumptions (for example where there is no existing case law) and is intended as a general, non-exhaustive guide:

	Specific CRA civil liability regime?	Provisions	Standard of Fault	Exclusion of liability possible
Austria	No	§§1293 ff ABGB(General Civil Code), (financial) damage (cf. §1293 s.1 ABGB) due to an unlawful (cf. §1294 s.2 ABGB) culpable (cf. §1295 par.1 ABGB) behavior esp. in breach of the CRA Regulation's (protection) requirements (cf. §1311 ABGB; called "Schutzgesetzverletzung")	Intention, negligence or carelessness	To a limited extent
Belgium	No	Article 1382 and 1383 of the Belgian Civil Code related to general non-contractual civil liability		In some cases, but not for fraudulent misrepresentation, or where such an exclusion empties the obligations of their substance

	Specific CRA civil liability regime?	Provisions	Standard of Fault	Exclusion of liability possible
Cyprus	No	Civil Procedures Rules, Civil Wrongs Law, Contract Law, Law of Evidence	Various, including intent	Yes
Czech Republic	No	Act No. 40/1964 Coll., Civil Code, as amended, section 420	Negligence	Yes, except if caused by negligence or intention
France	Yes	Law 2010-1249 on banking and financial regulation of October 22nd 2010, article 10: codified into Monetary and Financial Code MFC (articles L. 544-4 to L. 544-6 in chapter IV of title IV of book V), referring to article 1382 and 1383 of Civil Code	Negligence, intent or omission	Under tort law, exclusion clauses generally considered null and void, however, claims under contract cannot rely on tort to void such exclusions
Germany	No	Bürgerliches Gesetzbuch (BGB), contract with CRA; § 611, § 433, § 459 BGB, third party; § 823 para 2 BGB, § 611, § 433, § 459 BGB	Intention, negligence	
Greece	No	914 Civil Code		By law or contract
Latvia	No	Article 1 of the Civil Procedure Law	No specific standard of fault	No
Lithuania	No	General provisions of civil liability established in the Civil Code of the Republic of Lithuania		
Luxembourg	No	Code civil, articles 1382 and 1383	Fault or negligence	No
Malta	No	Maltese Civil Code: Of Contracts: art. 993 Maltese Civil Code: Of Torts and Quasi Torts: art. 1031 – 1032, 1033, 1037, 1038, 1044, 1045, 1047, 1049 – 1051 Maltese Civil Code: Of the Effects of Obligations: 1125 – 1141	Negligence, intent	Yes, in some cases, exclusion clauses must be consented to by all parties and not be illegal or contrary to public policy

	Specific CRA civil liability regime?	Provisions	Standard of Fault	Exclusion of liability possible
Netherlands	No	Dutch Civil Code (CC), 6:162 CC (non-contractual liability) or 6:194 CC (misleading advertisement) (lex specialis of the above general tort provision)	Likely to be negligence	Yes, but not for non-contractual liability, though it can be limited to a certain extent
Poland	No	Article 415 of the Civil Code	No specified standards	Not for tort liability
Slovenia	No	Code of Obligations (OZ, Official Gazette of the Republic of Slovenia, Nos. 83/2001… 97/2007), Articles 131-189	Intent or negligence	No
Sweden	No	Pursuant to the Swedish Tort Liability Act (SFS 1972:207), Chapter 2 Section 2		
UK	No	General law of contract and tort. In tort, the most relevant cause of action is likely to be the tort of negligence.	Contract, negligence	Yes, but only enforceable as far as court assesses such a clause to be reasonable

2.5. Conflicts of Interest due to remuneration models

In the following the main remuneration models for credit rating agencies are presented followed by a description of potential conflicts of interest linked to the respective model.

Issuer-pays model

This model relates to the case where issuers solicit and pay for the ratings of their own debt instruments. The issuer-pays model is by far the dominant remuneration model currently used by credit rating agencies. On average, the revenue generated by the issuer-pays model represents more than two-third of total CRAs' revenues.

The issuer-pays model entails conflicts of interest by its nature. The inherent conflict of interest in this model is that rating agencies have a financial interest in generating business from the issuers that seek the rating, which could lead to assigning higher ratings than warranted in order to increase its revenues from the issuer. A low rating might affect future business. If reputational concerns or regulation are not strong enough to discipline credit rating agencies, the issuer-pays model can result in inflated ratings.

Investor/subscriber-pays model

Under this model, credit rating agencies would earn fees from users of the ratings. In the mid-1970s, as credit ratings started to become more important because of the increasing reliance on ratings in rules and regulations, CRAs stopped selling ratings to investors and instead began charging the companies that issue the debt they rate. Still, in the US, some of the smaller CRAs, such as Egan-Jones Rating Company (which focuses on corporates), Lace

Financial Corporation, and Realpoint, LLC (which focuses on structured finance), use the investor/subscriber-pays models.

Even if the conflicts of interests related to the investor/subscriber-pays model are in general considered to be less strong than those attributed to the issuer-pays model, the investor-pays model is by far not free form conflicts of interests: A large investor may try to influence CRAs to provide lower initial ratings (which tend to provide higher yields), while institutions that can only invest in highly rated instruments due to regulatory requirements might pressure a CRA to assign an investment-grade rating on a particular security.

It has also been shown that under the "investor-pays" model there is the risk of "free-riders" when an investor accesses the information paid by another investor, without having to support the cost of the information production[258].

Moreover, some experts doubt whether the investor-pays model would provide enough resources for credit rating agencies to deliver high quality ratings and employ a sufficient number of analysts, as investors are not always able or willing to pay for rating services. Ultimately the investor-pays model could marginalise ratings for smaller issuers and less liquid issuances.

The public utility/government model

This model is currently not applied in practice. It would require transforming a credit rating agency into a public utility and funding it with government revenues.

Also the public utility/government model is not free from conflicts of interest, especially with regard to sovereign debt ratings. It involves taxpayers' money.

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[258] A user/investor-pays-based business model is difficult to maintain because of the inability to restrict access to ratings and their public good characteristic of aggregating difficult-to-obtain private information. See the International Monetary Fund, World Economic and Financial Surveys Global Financial Stability Report, October 2010, p.14.

ANNEX VII. DESCRIPTION OF OPTIONS

Identified policy options regarding objective 1 - *Diminish the impact of "cliff" effects on financial institutions and markets by reducing reliance on external credit ratings*

Policy option	Description	(Potential) Instrument
Option 1 (baseline)	The baseline scenario applies.	
Option 2 (Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes)	All explicit references to external credit ratings in regulatory capital frameworks for financial institutions would be reviewed. This would include the guidelines from the European Supervisory Authorities. A specific obligation should be included in EU legislation encouraging European Supervisory Authorities to use other means for assessing creditworthiness rather than pure reliance on ratings. Option 2 would require financial firms (credit institutions, investment firms, insurance and reinsurance undertakings, pension funds, UCITS managers and in the future alternative investment fund managers) to assess the credit/market risk using their own methodology. Financial firms' investment decisions would not rely solely or mechanistically on external ratings but would have to be based in addition, on information obtained through own due diligence, external research or market based measures (such as CDS prices). Firms with material and complex credit risk exposure (banks, certain investment firms, insurance and reinsurance undertakings) will be required to develop and use internal models for the calculation of capital requirements, rather than relying on external ratings under a standardized approach. Standardised approach would remain available for smaller institutions for which the development of internal models would be disproportionate or for those institutions whose exposure to credit risk is less material or less complex. However, also those firms would have to assess if the inherent credit risk of an exposure is significantly higher than the one that corresponds to the capital requirement assigned under the standardised approach based on external ratings, and to reflect the higher degree of credit risk in the evaluation of their overall capital adequacy. This measure is also recommended by FSB and thus would ensure coherence at the international level. It should also be made sure that references to external ratings will be avoided to the extent possible in any future EU legislation including technical standards and guidelines	*All references to ratings in EU Financial* *CRDIV proposal as adopted on 20 July 2011. Solvency II implementing measures*[259]*, UCITS*[260] and *AIFMD*[261]

[259] Implementing measures of Solvency II are expected in Q2 2012.

[260] Directive 2009/65/CE of the European Parliament and the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009.

[261] Alternative Investment Fund Managers (AIFM) Directive ("AIFMD"). On 11 November 2010, the European Parliament and the Council have reached a political agreement on the "Draft Directive" and the publication of the Directive in the Official Journal of the European Union is expected in Q1 2011.

Policy option	Description	(Potential) Instrument
	of the European Supervisory Authorities.	
Option 3 (Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating, if available)	This option would require credit institutions, investment firms, insurance and reinsurance undertakings to use at least two credit ratings issued by different credit rating agencies, where available. These ratings would be required to be used for the calculation of capital requirements under the standardized approach.[262]	*Solvency II*
Option 4 (Improve disclosure requirements for issuers of structured finance products on an ongoing basis)	Improve disclosure requirements for issuers of structured finance products on an ongoing basis, enabling the disclosure of the main elements of underlying asset pools for structured finance products necessary for investors to make their own credit assessment and thus not rely on external ratings. Issuers could disclose this information by means of a website.	Amendment of the CRA Regulation

Identified policy options regarding objective 2 - *mitigate risks of contagion effects linked to sovereign debt ratings*

Policy option	Description	(Potential) Instrument
1. No policy change	The baseline scenario applies.	
2. Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff	Strengthen existing disclosure requirements for solicited and unsolicited sovereign debt ratings by requiring CRAs to disclose free of charge their full research reports on sovereign debt ratings in order to improve transparency and enhance users' understanding. This option could also include the publication of additional figures on the allocation of staff in the annual transparency report.	Amendment of CRA Regulation (*CRA III*)
3. Require CRAs to publish sovereign ratings after closing of EU trading venues	Require CRAs to publish sovereign debt ratings only after the close of business of European trading venues ensuring that all market participants can obtain a full understanding of any change of a rating.	Amendment of CRA Regulation (*CRA III*)
4. Require CRAs to conduct the sovereign debt ratings process more frequently	Strengthen the current review requirement for credit ratings by requiring CRAs to assess sovereign debt ratings more frequently. This could entail, for instance, the reduction of the maximum time period after which sovereign debt ratings have to be fully assessed to six months from twelve as currently provided for in article 8 (5) of the CRA regulation.	Amendment of CRA Regulation (*CRA III*)
5. Extend powers of competent authorities (ESMA) to scrutinize rating methodologies	Extend the powers of the ESMA by requiring registered CRAs to notify it in advance of any change to rating methodologies. This could apply for methodologies of sovereign debt ratings and also for other asset classes. ESMA would scrutinize whether the changed methodology complies with the criteria in Art. 8 (3) of	Amendment of CRA Regulation (*CRA III*)

[262] Basel II: under this approach banks are required to use ratings from External Credit Rating Agencies to quantify required capital for credit risk.

Policy option	Description	(Potential) Instrument
	the CRA Regulation will be specified in the future regulatory technical standard. In doing so, ESMA shall not interfere with the content of credit rating methodologies as required in article 23.1 of the CRA regulation. Only after a positive assessment by ESMA the CRA may proceed with the new methodology. Furthermore, ESMA shall be empowered to restrict for a limited period the issuance of ratings if it has sufficient concern that a CRAs methodology or application of a methodology is in danger of infringing the Regulation.	
6. Require (EU) sovereigns to publish a standardized set data on economic performance to enable credit risk assessment	Require sovereigns to disclose a limited and standardised set of relevant information necessary for investors to perform their own credit assessment which would be published on a centralised website, facilitating comparability of standardized information for investors.	Amendment of CRA Regulation (*CRA III*)
7. Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in situations defined by the Regulation	Define the exceptional conditions under which a temporary banning or restriction of sovereign ratings could be imposed in the Regulation. These exceptional situations could include an event that poses a threat to financial stability, market confidence, excessive volatility or cases where there are ongoing negotiations on a financial assistance programme for EU Member State. Detailed criteria for determining an exceptional situation would be determined by means of a delegated act.	Amendment of CRA Regulation (*CRA III*)
8. Encourage an existing, independent EU structure or a brand new European Credit Rating Agency to issue credit ratings	Encourage an existing independent EU structure (ECB) or promote a brand new European Credit Rating Agency to issue independent credit assessments, particularly for European sovereigns. These assessments could include a detailed research report and methodology and would be published and remain freely available for investors, offering an independent alternative to existing commercial credit ratings. Existing EU structures such as the ECB or ESM could be encouraged to provide such a service.	Amendment of ECB Regulation Or Council and Parliament Regulation (New Agency)
9. Prohibit sovereign debt ratings	Prohibit registered and authorised credit rating agencies from issuing sovereign debt ratings. Investors would be required to perform their own assessment of sovereign debt products based on all relevant publicly available information.	Amendment of CRA Regulation (*CRA III*)

Identified policy options regarding objective 3 - *improve credit rating market with a view to enhance competition and improve ratings quality*

Policy option	Description	Instrument
1. No policy change	The baseline scenario applies.	
2. Encourage the emergence of a network of small and medium size rating agencies	A network of European small and medium size rating agencies would be promoted under a European Programme. This could consist of a specific action	The common strategic framework for

Policy option	Description	Instrument
	under the Competitiveness and Innovation Programme (CIP) [263] of the Enterprise and Industry Directorate General, which would fall under the financial perspectives of the period 2012-2017. This network would enable participating small and medium rating agencies to share data, best practice on rating methodologies and resources.	research and innovation funding (Horizon 2020) or the new Competitiveness and SME programme for the continuation of the non-innovative actions of the CIP
3. Encourage the emergence of a new European rating agency	The emergence of a fully independent European rating agency in the structure of a private foundation or in the form of a new Public Agency (see above option 8 of previous section). To support the private foundation an initial funding to cover start-up costs for the first three to a maximum of five years could be provided through the European Investment Bank (EIB) or our of the Union Budget	Financing decision of the Commission + Grant agreement (direct or following call for tenders)
4. Harmonise ratings scales to improve comparability of ratings between CRAs	ESMA would be empowered to prepare draft technical standards on a harmonised rating scale to be used by registered CRAs. All ratings would need to follow the same rating scale standards, ensuring that ratings can be compared more easily by investors. Furthermore, this could include common definitions on sovereign default.	Amendment of CRA Regulation (*CRA III*)
5. Establish a European Rating Index (EURIX)	All rating agencies would be required to communicate all ratings to ESMA, which would publish all available ratings on the market for a debt instrument in the form of European Rating Index (EURIX), which would be freely available for investors.	Amendment of CRA Regulation (*CRA III*)
6. Require CRAs to issue joint ratings at the level of the rating committee	Small and larger CRAs would be required to work together in order to issue a joint credit rating. This option will thus provide opportunities for the smaller agencies to gain exposure, demonstrate capability and build reputation over time so that they become real competitors to the current large CRAs, not only in terms of size and expertise, but most importantly reputation. More than one CRA would be involved in issuing a rating for corporate issuers, structured finance instruments or sovereign debt and the 4 eyes principle would only apply to certain areas of the rating, mainly the final decision at the rating committee level.	Amendment of CRA Regulation *(CRA III)*
7. Ban large CRAs from	The larger CRAs would be prevented from acquiring	Amendment of

[263] The Competitiveness and Innovation Framework Programme (CIP) supports innovation activities, provides better access to finance and delivers business support services in the regions. The Enterprise and Innovation Programme (EIP), one of the specific programmes under the CIP, seeks to support innovation and small and medium sized enterprises (SMEs).

Policy option	Description	Instrument
acquiring small and medium-sized CRAs	small and medium-sized CRAs. The main purpose is to ensure the active presence of a much higher number of CRAs in the EU market once other measures to facilitate the growth of smaller CRAs come into effect.	CRA Regulation *(CRA III)* + Amendment of the Merger Regulation
8. Introduce temporary market share ceilings for CRAs	No CRA would be allowed to have more than a certain percentage, for example 20%, of total market share. The purpose of this measure is to alter the current oligopolistic market structure. The process would have three phases: (1) transition period (for example, 5 years) under which CRAs would need to accommodate their rating business to the ceiling's requirement; (2) monitoring period (for instance, 10 years) under which the smaller CRAs will have the possibility to expand their business and build up their reputation to become real competitors to large CRAs; (3) the end of the temporary restriction period under which all requirements on ceilings would be removed.	Amendment of CRA Regulation *(CRA III)*
9. Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs	CRAs would be required to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs, in an aggregated format, so that issuers have clarity on the amount of fees that CRAs charge. The information should be transparent and accurate and cover all rated asset classes, possibly in aggregated format and via a website. Furthermore, to avoid potential conflicts of interest in the provision of rating and ancillary services, CRAs will have to ensure that the prices and fees they charge for their services are (a) not discriminatory, i.e. fully based on the costs and transparent pricing criteria ; (b) not based on any form of contingency.	Amendment of CRA Regulation *(CRA III)*

Identified policy options regarding objective 4 – *ensure right of redress for investors*

Policy option	Description	Instrument
1. No policy change	The baseline scenario applies.	
2. Introduce civil liability of CRAs into EU legislation	Investors could directly base claims against CRAs that have infringed the CRA Regulation and caused damage to the investor on a provision in the CRA Regulation which would specify all conditions for civil liability of CRAs. Civil liability of CRAs would thus be regulated at the Union level and no longer in Member States' own civil law orders.	Amendment of CRA Regulation (*CRA III*)
3. Ensure civil liability of CRAs towards users of credit before national courts	This option would ensure civil liability of CRAs towards investors before national courts in case a CRA infringes the CRA Regulation thereby causing damage to an investor having relied on a flawed rating. Common principles under which CRAs should be held liable (eg. standard of proof) would be defined.	Amendment of CRA Regulation (*CRA III*)

Identified policy options regarding objective 5 - *improve ratings quality by reinforcing independence of credit rating agencies and promoting sound credit rating processes and methodologies*

Policy option	Description	Potential Instrument
1. No policy change	The baseline scenario applies.	
2. Require institutional investors to obtain their own ratings before they can purchase a particular financial instrument	The issuer would remain free to hire its own rating agency, but each institutional investor would be required to obtain its own independent rating before investing in a particular financial instrument for amounts above certain thresholds (e.g. for clients who may be treated as professionals and whose investment portfolio exceeds EUR 500,000[264]).	Amendment of CRA Regulation (*CRA III*)
3. Require trading venues to set up and ensure the administration of the "Trading venues pay" model	Trading venues would be required to ensure and organise the rating of listed and traded companies and instruments. As the bulk of global securities is traded outside traditional trading venues, for non-listed companies and instruments, the "Subscriber / Investor Pays" model could apply. The platform would be required to organise the rating of a pool of loans by one of CRAs. Selection of the CRA rating an instrument could be made on the basis of objective criteria.	Amendment of MiFID
4. Require CRA selection to be undertaken by an independent board	An independent "Credit Rating Agencies Board" composed of supervisors, representatives of issuers, subscribers and investors and credit rating agencies would be empowered to select a CRA either at random or on the basis of objectively defined criteria to rate an issuer's structured finance instruments. The issuer would remain free to (1) secure no rating from selected CRA at all, or (2) hire additional CRAs if desired.	Amendment of CRA Regulation (*CRA III*)
5. Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself and in introduce mandatory separation between them	An issuer's own credit worthiness could not be rated by the same CRA for more than 3 consecutive years. Another CRA would take over thereafter and the outgoing CRA and the issuer would make available all information accessed in the rating process, and hand over appropriately to the incoming CRA to enable it to perform ratings effectively. A CRA would not be able to rate more than 5 consecutive issues of any asset class by the same issuer, or if fewer than 5 issues are made, it would not be able to rate the issues of one issuer over a period exceeding 3 years. After a CRA has rated 5 consecutive issues for an issuer, that issuer must then solicit any ratings for at least its 5 following issues from a different CRA or CRAs or if fewer than 5 issues are made, for a maximum period of three years. Then, after 3 years have passed or 5 issues have been made, whichever is sooner, the issuer could solicit ratings from the first CRA again if desired. Furthermore, mandatory separation between the rating of an issuer and	Amendment of CRA Regulation (*CRA III*)

[264] The investment portfolio size refers to professionals in all investment services and activities and financial instruments as defined in Annex II, Professional Clients, II.1, "the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500.000", Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L0039, 28.04.2006.

Policy option	Description	Potential Instrument
	its products would be introduced, so that a CRA would not be able to simultaneously rate an issuer and its products. This rule should ensure that a range of CRAs are selected by an issuer to rate its products. CRAs should only rate products for which it has the capacity to rate in compliance with the CRA Regulation. This rule would only apply to solicited ratings, as it primarily addresses conflicts relating to the issuer-pays model. Unsolicited ratings could still be made at all times.	
6. Introduce specific requirements on CRAs' independence and objectivity in relation to their shareholders	Introduce specific requirements on CRAs' independence and objectivity in relation to their shareholders. ESMA would be required to ensure: (1) shareholders could not either individually or in voting blocs accrue potentially controlling stakes in more than one CRA, (2) that CRAs could not issue ratings for any firm that holds shares in that CRA, even indirectly (3) any person that directly or indirectly controls a CRA would not be allowed to invest in products and entities rated by the CRA and to provide advisory services to the entity which or whose products were rated.[265]	Amendment of CRA Regulation (*CRA III*)
7. Strengthen rules on disclosure of rating methodologies	Existing rules on rating methodologies would be strengthened by (1) extending the requirement to disclose methodologies and underlying assumptions behind ratings from structured finance products to all asset classes, (2) enhancing the requirement to disclose material changes in methodologies by additionally requiring the publication of clear reasoning and justification for the changes and (3) enhancing the requirement to disclose errors in methodologies or their application by requiring immediate disclosure directly to the affected parties including investors, issuers and competent authorities.	Amendment of CRA Regulation (*CRA III*)
8. Require CRAs to inform issuers sufficiently in advance of the publication of a rating	Exiting disclosure requirements[266] for solicited and unsolicited ratings would be strengthened by requiring CRAs to inform issuers for which they are in the process of issuing a rating sufficiently in advance of the publication of the rating, of the principle grounds on which the rating is based. This could include a requirement to elaborate on the main assumptions which justify the change of rating and would apply both to solicited and unsolicited ratings.	Amendment of CRA Regulation (*CRA III*)

265 This option is in line with existing company law and free movement of capital provisions.

266 This option would extend the current requirement of 12 hours, provided for in Annex I D (3) which does not reflect the working hours available to perform an assessment.

ANNEX VIII. ANALYSIS OF THE IMPACT OF POLICY OPTIONS ON STAKEHOLDERS

Policy options regarding objective 1 – *reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes*

	Impact on stakeholders
Option 1 (baseline)	*n.a.*
Option 2 (Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes)	*Regarding the use of internal rating models:* *(++) individual investors reassured that management of investment risk is restoring confidence* *(-)the relevant financial companies bear ongoing and higher compliance cost* *(+) financial institutions gain comfort that both enhanced credit risk management systems and external credit ratings would mitigate exposures, but would need to adapt compliance systems* *(0) issuers – no obvious costs or benefits* *(++) sovereigns/taxpayers – gain comfort that financial institutions less likely to be bailed out* *(+/-) CRAs incentivised to constantly improve rating quality. However, a shift to internal rating models will reduce the business activity of CRAs, which may affect the quality of the services delivered by CRAs* *(+) supervisors gain comfort that financial institutions do not mechanistically rely on external ratings, but need to supervise* *Regarding the use of standardised approach:* *(++) individual investors obtain reassurance that risk of "cliff" effects on financial institutions would be mitigated* *(-) financial institutions bear on-going and higher compliance costs* *(0) issuers – no obvious costs or benefits* *(++) sovereigns/taxpayers gain confidence in sustainability of financial institutions* *(+) CRAs – the requirement for credit institutions to compare internal ratings with external ratings may incentivize CRAs to constantly improve their rating methodologies* *(-) supervisors would need to ensure in supervisory processes that rules are applied*
Option 3 (Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating, if available)	*(0) individual investors - investors could face some additional searching cost.* *(-) financial institutions bear higher compliance cost to search for ratings and apply* *(0) issuers - issuers will not bear additional cost as it is not an obligation to obtain 2 ratings.* *(0) sovereigns/taxpayers – will not bear additional cost as it is not an obligation to obtain 2 ratings.* *(+) CRAs would potentially increase the rating market sizeze*
Option 4 (Improve disclosure requirements for issuers of structured finance products on an ongoing basis)	*(++) individual investors and financial firms would benefit from increased product information* *(--) issuers face compliance costs to disclose and they may reduce the information for external credit ratings* *(++) sovereigns/taxpayers benefit from possible reduced capital market volatility* *(++) CRAs incentivised to improve the rating quality and to provide unsolicited ratings* *(-) supervisors would need to ensure in supervisory processes that rules are applied*

Policy options regarding objective 2 – *mitigate risks of contagion effects linked to sovereign debt ratings*

	Impact on stakeholders
Option 1 (baseline)	*n.a.*
Option 2 (Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff)	*(++) improves transparency of sovereign debt ratings to investors including credit institutions* *(+) improves transparency on sovereign ratings towards sovereigns* *(-) CRAs face opportunity costs as they could loose some revenue from selling research reports.*
Option 3	*(+) improves transparency of sovereign debt ratings to investors and ensures that all market participants have same information on ratings of sovereigns issuers*

	Impact on stakeholders
(Require CRAs to publish sovereign ratings after closing of EU trading venues; Introduce a requirement to CRAs to publish sovereign ratings after closing of EU trading venues)	*(+) ensures good communication on rating changes for sovereign issuers.* *(+) clear and transparent rules on timing of disclosures of ratings by CRAs.*
Option 4 (Require CRAs to conduct the sovereign debt ratings process more frequently)	*(+) improves transparency of sovereign debt ratings to investors, ensures all market participants have up to date information on ratings of sovereigns issuers* *(+) Sovereigns will benefit from improve transparency to investors* *(-) CRAs would need to conduct full rating process more frequently and could face therefore limited additional costs*
Option 5 (Extend powers of competent authorities (ESMA) to scrutinize rating methodologies for sovereign debt ratings (and any other ratings with financial stability implications))	*(+) increased power for competent authorities to scrutinize ratings* *(+) investors would benefit from improved quality and scrutinized rating methodologies for sovereign ratings* *(-) limited risks that independence of CRAs with regard to rating methodologies is undermined. CRAs would need to ensure that rating methodologies are sufficiently justified and explained.*
Option 6 (Introduce a requirement for (EU) sovereigns to publish a standardized set data on economic performance to enable credit risk assessment)	*(+) easy access to investors to this information to ensure they can make own assessment.* *(-) additional disclosure for sovereigns of already available information* *(+) easy access for CRAs on already available information to perform ratings.*
Option 7 (Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in exceptional situations)	*(++) Investor, credit institutions and sovereigns will benefit from reduced risks of further contagion effects in exceptional cases undermining market stability* *(-) Sovereigns subject to the ban could face risks that new issuances would have limited market interest due to absence of a rating due to the temporarily ban.*
Option 8 (Encourage an existing, independent EU structure or a brand new European Credit Rating Agency to issue credit ratings)	*(+) investors benefit from improved information through an additional independent and credible source of credit opinions.* *(+)sovereign issuers and systemic credit institutions benefit from additional credit opinions are available from an credible source* *(-) EU structure entails risks that independence could be questioned by investors.* *(-) CRAs would be subject to more competition from a stakeholder with important reputation*
Option 9 (Prohibit sovereign debt ratings)	*(-) lack of existing alternatives for investors and limited knowledge to make own assessment* *(-) some credit institutions might face difficulties to further invest in sovereign debt instruments.* *(-) some sovereigns might experience problems to find sufficient investors when issuing sovereign debt due to lack of ratings* *(-) SMEs will need to set up their internal assessment for sovereigns* *(-) CRAs deprived from revenue source*

Policy options regarding objective 3 – *improve credit rating market conditions with a view to improve ratings quality*

	Impact on stakeholders
Option 1 (baseline)	*n.a.*
Option 2 (Encourage the emergence of a network of small and medium size rating agencies)	*(++) investors will obtain more choice of ratings and rating agencies ensuring they can better compare credit opinions and make their own decisions.* *(++) issuers would have more choice for rating agencies which could lead to lower prices* *(-) large CRAs would become subject to more competition in rating industry;*

	Impact on stakeholders
	(+) small and medium SMEs would be stimulated to enter rating market at larger scale
Option 3 (Encourage the emergence of a new European rating agency)	*(+) an additional source of credible and independent credit ratings would be available to investors* *(-) new market entrants could face competition by a new EU CRA.* *(+) issuers will have more choice of sizeable rating agencies.* *(-) CRAs would be subject to more competition from a new agency with considerable size*
Option 4 (Harmonise ratings scales to improve comparability of ratings between CRAs)	*(+) improved understanding and comparison of ratings by investors* *(+) issuers might benefit from better prices due to more competition* *(+) small CRAs will benefit from better visibility on ratings* *(-)large CRAs would face more competition due to better comparability*
Option 5 (Establish a European Rating Index (EURIX))	(+) investors benefit from improved transparency on ratings available from distinct CRAs ensuring they can better perform their own assessment (+) issuers might benefit from better prices due to more competition (+) small CRAs will benefit from better visibility on ratings (-) large CRAs would face more competition due to better comparability
Option 6. (Require CRAs to issue joint ratings at the level of the rating committee)	*(-) The reputational advantage of Big Three CRAs versus smaller CRAs would decrease overtime* *(+) The reputational disadvantage of smaller CRAs would decrease overtime* *(-) the increase of cost for issuers competition in the market* *(+) investors might profit from higher rating quality and increased reliability of their ratings*
Option 7 (Ban large CRAs from acquiring small and medium-sized CRAs)	*(-) bigger CRAs will be in banned from acquiring/ merging with smaller CRAs* *(+) smaller CRAs would be in a better position if the further expansion/ consolidation will be banned for bigger CRA.* *No substantial impact of this measure is foreseen on issuers or investors*
Option 8 (Introduce temporary market share ceilings for CRAs)	*(-) CRAs whose market share exceeds the threshold will have to give up some clients).* *(+) Smaller (or new market entrants) CRAs will benefit from the growth opportunities* *(-/+) issuers might face higher prices in short run. In long-run however issuers will have more choice among CRA.* *(≈/+) during the phase-in period (first 5 years) investors will be more inclined to shop for unsolicited ratings. In long-run, investors will benefit from more choice in the market*
Option 9 (Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs)	*(+) issuers, investors, other purchasers of CRAs services will benefit for more transparency on the fees charged for CRAs services but also from strengthened independence stemming from restrictions on CRAs' abilities to negotiate fees individually with each client* *(+) smaller/growing CRAs will benefit from more favourable market conditions due to price transparency and prohibition of price discrimination* *(-) large CRAs will face more competition due to increased transparency and limits of price discrimination.*

Policy options regarding objective 4 - *ensure right of redress for investors*

	Impact on stakeholders
Option 1 (baseline)	*n.a.*
Option 2 (Introduce civil liability of CRAs into EU legislation)	*(+) investors benefit from effective right of redress and from high quality ratings due to preventive effect on CRAs behaviour* *(+/-) CRAs would be incentivised to produce high quality ratings but may face restricted business opportunities. In addition, CRAs could face civil liability claims from investors* *(+) issuers indirectly profit from higher rating quality and increased reliability of their ratings* *(+) positive impact on right to an effective remedy and a fair trial (Art. 47 Charter)*
Option 3 (Ensure civil liability of CRAs towards users of credit ratings before national courts)	*(+) investors benefit from effective right of redress and from high quality ratings due to preventive effect on CRAs behaviour* *(+/-) CRAs would be incentivised to produce high quality ratings but may face restricted business opportunities. In addition, CRAs would face civil liability claims from investors* *(+) issuers indirectly profit from higher rating quality increased reliability of their ratings* *(+) positive impact on right to an effective remedy and a fair trial (Art. 47 Charter)*

Policy options regarding objective 5 – *Improve ratings quality by reinforcing independence of credit rating agencies and promoting sound credit rating processes and methodologies*

	Impact on stakeholders
Option 1 (baseline)	*n.a.*
Option 2 (Require institutional investors to obtain their own ratings before they can purchase a particular financial instrument)	*(+/-) investors would have a greater number and variety of ratings at their disposal.. However, at the same time, this option may discourage investors from conducting their own due diligence. Investors would bear most of the compliance costs* *(-) issuers may face difficulties raising funding (it would become more expensive)* *(+) sovereigns/taxpayers gain comfort that alternative remuneration models would bring more transparency to the market and would therefore contribute to the stability of capital markets* *(+/-) CRAs gain a new investor pays rating market. However, it would reduce the issuer pays market* *(+/-) supervisors gain comfort that conflicts of interest due to the issuer pays model would be mitigated. However, the FSB principles may be violated as reliance on external credit ratings would increase*
Option 3 (Require trading venues to set up and ensure the administration of the "Trading venues pay" model)	*(+) investors would be assured high quality ratings free of conflicts of interest* *(--) issuers may have difficulty raising funds. They would bear higher on-going costs. It may also reduce market liquidity* *(+) sovereigns/taxpayers gain comfort that the stability capital markets would be improved* *(-) CRAs could lose interest in constantly reviewing and improving the quality of ratings* *(+/-) supervisors obtain full independence of credit ratings on listed instruments, but may face further difficulty regulating unlisted instruments*
Option 4 (Require CRA selection to be undertaken by an independent board)	*(+) investors would be assured ratings exposed to lower potential risk of conflicts of interest* *(0) issuers – no obvious costs or benefits* *(-) CRAs could face more difficulty in developing business as it would not have complete control over the amount of business it takes on. Potential market entrants could face difficulties in proving accuracy and developing reputational capital. There could also be a reduced incentive for CRAs to compete on the basis of rating quality and streamline their operational performance*
Option 5 (Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself and in introduce mandatory separation between them)	*(++) Ratings rotation would bring more liquidity into the rating market* *(++) investors could gain further comfort that issuers are not affecting ratings and that they are issued with reduced conflict* *(+/-) issuers could be concerned that agencies are less likely to compete on rating quality, and they could be forced to pay higher fees if a CRA was more certain to gain business from them* *(+) sovereigns/taxpayers could gain comfort that rating agencies could be less subject to some conflicts of interest, and that sovereign ratings issued* *(-) CRAs with strong reputations and successful ratings track records could face more competition from CRAs with lesser reputation and track records* *(+/-) supervisors should not incur significant additional burden*

	Impact on stakeholders
Option 6 (Introduce specific requirements on CRAs independence and objectivity in relation to their shareholders)	*(++) investors could gain comfort that further potential conflicts of interest would be mitigated, giving them further confidence in ratings without being under additional obligations themselves* *(-) issuers may have to take further steps in identifying conflicts before approaching CRAs for ratings* *(+) sovereigns/taxpayers could gain comfort that there would be more transparency and a reduction in conflicts, leading to improve ratings* *(-) CRAs may have to take further steps in identifying conflicts before accepting certain issuers as clients* *(+/-) supervisors might face resource burdens in analysing data in order to enforce these requirements. They may, however, develop greater market oversight*
Option 7 (Strengthen rules on disclosure of rating methodologies)	*(++) investors could become better informed about rating methodologies and would gain further understanding of the rating process. They could also have quicker access to more detailed information on ratings* *(++) issuers could gain greater clarity about the methodologies and about the effect of changes to them on their instruments' and their own ratings* *(+) sovereigns/taxpayers do not appear to incur any additional burden due to this option, sovereigns might have the chance to provide feedback on methodologies, and will also have greater clarity of the market* *(-) CRAs may have to delay updates to methodologies if obliged to consult. Changes could mean greater cost of updated analysis and communications with stakeholders* *(++) supervisors do not appear to incur any additional burdens due to these changes, but would gain comfort that market participants were better and more quickly informed of developments in the market due to methodology changes, and could benefit from increased due diligence at supervised firms (who may be encouraged by easier access to methodologies)*
Option 8 (Require CRAs to inform issuers sufficiently in advance of the publication of a rating)	*(+/-) investors could gain greater confidence on credit ratings, but the reliance on external ratings might increase* *(++) issuers could gain greater clarity about the methodologies and they would have an opportunity to draw attention of the credit rating agency to any factual errors before the rating publication* *(++) sovereigns could gain greater clarity about the methodologies and they would be able to check the ratings before the publication* *(-) CRAs may have to delay issuance and update of ratings. Delay could mean a risk of insider dealing and greater cost of analysis and communications with stakeholders* *(++) supervisors do not appear to incur any additional burdens due to these changes, but would gain comfort that market participants would have more reliable ratings, specifically on sovereign debt ratings*

ANNEX IX. ENCOURAGING AN EXISTING, INDEPENDENT EU STRUCTURE OR PROMOTE A BRAND NEW EUROPEAN CREDIT RATING AGENCY TO ISSUE SOVEREIGN DEBT RATINGS

Under this option an existing EU structure with adequate resources and capacity or a brand new European Credit Rating Agency would issue credit ratings for sovereign issuers to provide market participants with a greater variety of opinions on credit worthiness. As regards the use of an existing EU Institutions, only the option 'ECB/ESCB' is assessed since the other two (Commission and EFSF/ESM) would be less efficient and effective (see analysis in section. 6.3).

Sub-options

The implications of the following range of concrete models are considered:

- EU ratings provide by the European Central Bank in cooperation with the ESCB
- Independent EU rating agency, fully financed by the Union budget (see Annex XI).

a) EU ratings issued by the European Central Bank

Under this sub-option the European Central Bank would determine and issue independent credit assessments, particularly for European sovereigns, based on information provided by the Member States. These assessments, including a detailed research report and methodology would be published on their respective websites and remain freely available or investors, following the "government pays model" and offer an alternative to existing commercial credit ratings.

To establish the credit assessments of European sovereigns, the institution could base itself on already reported information provided by the ESS (European Statistical System) coordinated by EUROSTAT.

The ECB would remain free to modify these credit assessments at any moment in time and update the assessment at least periodically (for instance twice a year).

The staff of the service would consist of approximately 150 up to 250 independent ECB Officials necessary to perform the ongoing credit assessment for all EU sovereigns and systemic credit institutions. This would ensure that at least 2 experts per sovereign are available for small Member States and 3-5 experts are available for large sovereigns. These assumptions were made based on input received from industry experts within the rating market.

Based on an annual cost of EUR 75.000 per full time equivalent, as this activity will require highly skilled economic profiles, and including overhead costs in the range of 20%-30% of headcount, this would result in an incremental annual cost of 13.5-24.4 Million to be covered by the EU budget.

It should be noted that in its contribution to the public consultation, the ECB considered this policy measure beyond is task. Furthermore, other responses of public consultation raised concerns regarding to credibility and independence of an public EU structures to issue credit ratings.

Table 1: Key elements of ratings by ECB

	Ratings by ECB	**Objective**
Concept	The ECB performs and publishes periodically credit ratings of sovereigns (EU-Member States or EEA-Member States), on validated information provided by Member States	Offer investors an alternative for private ratings for sovereign ratings which entail the largest risks of spill-over effects Ensure validation and certification of data provided by Member States Ensure independency of credit assessment
Legal setup and ownership	EU regulation, Union ownership	
Funding	Union Budget	Ensure there is only indirect payment by issuer through the Union budget
Payment model	Government Pays model, Free usage for all investors	Ensure wide use and availability to investors Ensure all EU sovereigns and systemic credit institutions are continuously rated
Governance	European Central bank	Ensure independence from EU Member States and credit institutions
Staff	EU officials incremental 150-250 FTE to perform credit assessment for EU sovereigns and EU systemic credit institutions (Full Time Equivalents)	Ensure independence from Member States and credit institutions rated Capitalise on existing expertise available within the ECB
Type of ratings	Sovereign ratings	Ensure rating of entities with systemic and market stability implications which can be used for regulatory purpose
Budget/costs	Staff: EUR 11.2.-18.7 Million per year Total: 13,5 -24.4 Million per year	

Table 2: Detailed estimation of the costs implications under this option

Summary	Minimum EUR	Maximum EUR
Staff in full time equivalents (FTE)	150	250
Staff costs per FTE	75.000	75.000
Total staff costs	**11.250.000**	**18.750.000**
Overhead costs & IT	20%	30%
Total overhead costs	**2.250.000**	**5.625.000**
Total costs	**13.500.000**	**24.375.000**

ANNEX X. EUROPEAN NETWORK OF SMALL AND MEDIUM-SIZED CREDIT RATING AGENCIES

The idea of a European network of small and medium-sized Credit Rating Agencies received support from many small CRAs, Member States and regulators, including the ECB during the recent public consultation. Consequently, the feasibility of this idea is further explored below.

Benefits of a network/association

Integration of small and medium-sized credit rating agencies into a network or association would offer an opportunity to improve competitiveness of individual small and medium-sized credit rating agencies and allow them to expand into the rating of a wider range of entities or products, which in long-run would help to provide credible European alternatives to the services provided by the three major credit rating agencies.

A network could significantly reduce the costs for individual members due to the economies of scale in the development of common IT systems and other projects, the costs of which would be shared among the members.

The lower barriers to access the CRA market would increase the number and quality of ratings. More and better ratings would enhance investors' information and thus contribute to financially sound decision making.

The small and medium-sized credit rating agencies forming such a network of agencies should remain independent legal entities and would be subject to the current CRA Regulation. EU competition rules for co-operation between competitors should also be respected.

Fields of cooperation

CRAs could collaborate to create a common rating platform by sharing best practices and resources, building expert knowledge and enhancing the quality of ratings. A European network of small and medium-sized Credit Rating Agencies could help CRAs to e.g.:

1. build up expert knowledge and capable human resources
2. improve methodologies
3. ensure quality of rating processes
4. exchange data
5. facilitate analysis of cross border companies
6. ensure ratings comparability and consistency
7. develop joint marketing and sales strategies
8. disseminate rating results to wider public (joint website)
9. develop rating indexes
10. reinforce internal controls
11. educate investors
12. manage capacity problems
13. share or develop common IT systems
14. share legal, compliance and administrative functions

The need for the pan-European financial support

There are already some private initiatives to create a network of European CRAs, which however develop quite slowly and do not have a pan-European reach.
To speed up the creation of a true pan-European network of small and medium sized credit rating agencies it is therefore important that adequate financial incentives are established.

It is essential that EU financially contributes to the creation of such a structure to make it "up and running". Once the creation of a network is completed and the membership costs decrease substantially due to a sufficiently large number of members, the EU financial support in terms of co-financing the establishment and operations and projects of such a network from the EU-budget would be gradually terminated. It is suggested that the duration of co-financing should be limited in time (5 years). Afterwards, the network would become fully financed by the members of a network.

Expected participation

Based on the recent public consultations and discussions with stakeholders, 15 European CRAs may participate in such a network in the medium term (5 years).

Expected costs of the pan-European network

Based on calculations of external experts and depending on the level of integration, the indicative annual costs could for the establishment and operation of a network could be as shown in Table 1:

- Annual operation cost: 0.7-1.5 million EUR (own staff between 10 and 20 in 5 years, mostly dedicated to IT development)
- overhead costs in the range of 20%-30% of headcount

Table 1 : Detailed estimation of the costs implications under this option

Summary	Minimum EUR	Maximum EUR
Staff in full time equivalents (FTE)	10	20
Staff costs per FTE	75.000	75.000
Total staff costs	**750.000**	**1.500.000**
Overhead costs & IT	20%	30%
Total overhead costs	**150.000**	**450.000**
Total costs	**900.000**	**1.950.000**

Available means for the EU support

As discussed above, to make a pan-European network an attractive structure for a voluntary participation of CRAs, the initial costs of establishment and operation of a network should be supported.

In that respect the network could be supported making recourse to one of the two instruments under which the actions of the existing CIP (competitiveness and Innovation Framework Programme) will continue as from 2014 onwards[267], i.e.:

- the common strategic framework for research and innovation funding, called 'Horizon 2020";

- the new Competitiveness and SME programme for the continuation of the non-innovative actions of the CIP mentioned above.

The identification of the programme which would fit the best the funding of the proposed network will be done at a later stage when all the details of the two instruments mentioned will be known.

[267] The multiannual financial framework 2014-2020 "A budget for Europe 2020" COM (2011) 500 final of 29.6.2011.

Compliance with EU competition rules

Any network of small and medium-sized rating agencies would have to adhere to existing competition rules which apply to all companies in the EU. Information exchange between competitors can -depending on the market characteristics and the characteristic of the information exchange - be in contradiction with European Competition rules[268]. Any rules facilitating the cooperation between small and medium size rating agencies would thus have to be carefully drafted to ensure compliance with existing competition rules.

Exchange of information linked to rating methodologies and of statistics on aggregate and historical data (defaults, etc.) should normally be considered as consistent with EU competition rules, as they are unlikely to lead to a collusive outcome.

On the contrary, information exchange on CRAs individualised intentions concerning future conduct regarding prices and quantities (including intended future sales, market shares, territories, and sales to particular groups of consumers) must not be facilitated as exchange of such information is generally considered and fined as cartels. Furthermore, exchange of strategic data related to actual prices and quantities as well as other strategic information can have an appreciable adverse impact on one of the parameters of competition such as price, output, product quality, product variety or innovation. Such information exchange should be excluded.

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268 Communication from the Commission, Guidelines on the applicability of Article 101 of the Treaty on the Functionning of the European Union to horizontal co-operation agreements, OJ C11/1, 14.01.2011, para 55 – 110.

ANNEX XI. EUROPEAN CREDIT RATING AGENCY

Overall concept of a European Rating agency

One of the possibilities to increase the number of market participant in the rating agency industry is the introduction of a European rating agency. Such a move was considered in the public consultation on rating agencies and the European Parliament considered in its "own initiative report" that further analysis would be appropriate with regard to the design of a European rating foundation.

Proposal of the European Parliament regarding an independent European Credit Rating Foundation (ECRaF)

In its own initiative report prepared by Wolf Klinz, the European Parliament calls for a the establishment of a fully independent European Credit Rating Foundation (ECRaF)[269] which would expand its expertise into all three sectors of ratings including sovereign ratings, corporates and structured finance product. To ensure its credibility the management, staff and governance structure of the new ECRaF would need to be fully autonomous with regard to the Member States or any other public bodies. Furthermore, the European parliament considered that after a start-up period, the new ECRaF should be fully self sufficient. In the report, the European parliament asked the Commission to conduct a detailed impact assessment and feasibility study on the establishment of an independent ECRaF and to come forward with legislative proposals.

Sub-options

The implications of the following range of concrete models of European credit rating agencies are considered:

- Independent EU rating agency, fully financed by the Union budget
- Foundation, with public start-up financing

a) EU Public Rating Agency, financed by Union Budget

Under this option, a new and independent EU public rating agency would be established, which would issue independent credit assessments for EU Sovereigns and systemic credit institutions, hereby contributing to the monitoring of market stability. These independent credit risk assessments would be freely available for all investors and could be used by credit institutions or insurance entities for the purpose of determining regulatory capital.

The agency would be headed by an independent management board appointed for a period of 5 years and would staffed by 250-400 EU officials which would perform the credit risk assessments. This would entail [1-2] analysts per country dedicated for sovereigns small sovereigns and [2-5] for large sovereigns and 1 up to 3 analysts per systemic credit institution.[270]

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[269] European Parliament resolution of 8 June 2011 on credit rating agencies: future perspectives (Reference: 2010/2302 (INI), Rapporteur Wolf KLINZ, ADE, DE).

[270] It is considered that the same credit institutions which are subject to stress testing would obtain a credit assessment, which entails approximately 90 credit institutions. See communication from the European Banking Authority, press release 21 April 2011: www.eba.europa.eu.

Member States and systemic credit institutions would be required to provide any relevant information to the agency in order to perform the credit risk assessment. It should be noted that the majority of the information, particularly for sovereigns is already reported and processed by the ESS coordinated by EUROSTAT which would be re-used. Furthermore, credit institutions would need to provide a similar set of data as they already perform today for the purpose of European Stress testing.

The new EU public rating agency would entail an annual cost of EUR 24.4-39 million to be covered by the Union budget which includes headcount base on an annual cost of EUR75.000 per FTE and overhead costs representing 20%-30% of headcount costs as shown in table 2.

Table 1. key element of an independent EU rating agency

	EU rating service	**Objective**
Concept	A new EU agency would be set up to perform credit ratings for EU sovereigns and systemic EU credit institutions	Offer investors an alternative for private ratings for asset classes with financial stability concerns Ensure independency of credit assessment
Legal setup and ownership	EU regulation, Union ownership	
Funding	Union Budget	Ensure independence
Payment model	Government Pays model, Free usage for all investors	Ensure wide use and availability to investors
Governance	European Commission	Ensure independence from EU Member States
Staff	EU officials incremental 250-400 FTE (full time equivalents)	Ensure independence from Member States rated institutions
Type of ratings	EU Sovereigns and systemic EU credit institutions	Ensure that important asset classes are rated Capitalise on existing information and expertise available at EU-level
Budget/costs	Staff: EUR 18.8-30 Million per year Total: EUR 22.5 -39 Million per year	

Table 2: Detailed estimation of cost implications of this option

Summary	Minimum EUR	Maximum EUR
Staff in full time equivalents (FTE)	250	400
Staff costs per FTE	75.000	75.000
Total staff costs	**18.750.000**	**30.000.000**
Overhead costs & IT	20%	30%
Total overhead costs	**3.750.000**	**9.000.000**

Total costs	22.500.000	39.000.000

b) EU Rating Foundation, start-up financed first -5 years by the Union Budget

Under this option, a new and independent EU public rating agency would be established as a private foundation under national law and set up by private investors, including issuers and users of credit ratings. Furthermore, to ensure the agency can establish itself it would be financed the first 5 years with public funding. This could be undertaken through a public grant or a loan. This is the main distinction with previous option. Also under this option government would be attributed to an independent government board.

The independent foundation would establish credit assessments for a wide range of asset classes including Sovereigns and corporations (including credit institutions) and structured finance products, with particularly focus of debt instruments issued within the EU. Furthermore, foundation is expected to start off with sovereign ratings and credit institution within the short term, after which it would extend its scope to other corporations and structured finance products.

The foundation could operate according to the "investor pays" model. In this context, investors would need to pay a fee if the would want to obtain a rating.

The foundation would consist of an independent government board and consist of a workforce of 400-1200 analysts to perform ratings. The workforce would evolve gradually over time in line with the extension of the product reach covered, starting of with a limited staff to ensure that sovereigns and credit institutions can be rated, gradually extending to other corporate and structured finance products for which would require an increase of staffing

An EU rating foundation would entail an annual cost of EUR 39-97.5 million to be covered by the Union budget which includes headcount base on an annual cost of EUR 75.000 per FTE and overhead costs representing 20%-30% of headcount costs as shown in Table 4.

Under this option, during the first 5 years these operational costs would be borne by the Union budget. This financing could be provided through a loan provided by the European Investment Bank. After the initial period of 5 years, which should enable to EU rating foundation to establish itself on the market and reach a stable an sufficient client base, the loan would need to be paid back based on the by revenue linked to rating services according to the investors pays model.

Table 3. Key elements of an EU Rating Foundation, start-up financed first 5 years by the public sector

	EU rating service	**Objective**
Concept	A private foundation would be set up to perform credit ratings for a wide range of asset classes. This could include sovereigns and credit institutions, corporates and could over time cover structured finance products. Public sector funding necessary to finance start-up phase	Offer investors an alternative for private ratings for a wide range of asset classes Ensure independency of credit assessment

Legal setup and ownership	Private foundation with public financing for first 5 year.	Allow for fast set-up Ensure stable financing to ensure agency can establish itself on market.
Funding	Private/Public sector. Only start-up phase financed by public sector.	Ensure independence from public sector while
Payment model	Investors pays model [alternatively the existing "issuer pays" model could also be applied to this types of ratings]	Turn away from issuers pays model to avoid key conflict of interest
Governance	Private sector, maximisation of transparency through disclosure	Prevent third-party influence, ensure independence
Staff	Incremental 400-1000 FTE (full time equivalents) to perform of a wide range of asset classes	Ensure a wide range of assets can be covered over time
Type of ratings	EU Sovereigns , EU credit institutions, EU corporates and EU structured finance products	Step by step approach starting with sovereigns and extending to other asset classes.
Budget/costs	Staff: EUR 30 - 75 Million per year Total: EUR 39 -97.5 Million per year Public financing during first 5 years: EUR 195-487.5 million depending on the number of asset classes covered.	

Table 4: estimation of annual costs under this option.

Summary	Minimum EUR	Maximum EUR
Staff in full time equivalents (FTE)	400	1000
Staff costs per FTE	75.000	75.000
Total staff costs	**30.000.000**	**75.000.000**
Overhead costs & IT	20%	30%
Total overhead costs	**9.000.000**	**22.500.000**
Total costs	**39.000.000**	**97.500.000**

The public consultation outline strong opposition from a large majority of stakeholders with regard to a public European rating agency. The main concerns expressed regard the credibility and independence of a public agency. Furthermore, the costs in relation to such an initiative as as describe above cannot be underestimated.

ANNEX XII. ASSESSMENT OF ADMINISTRATIVE BURDEN AND COMPLIANCE COSTS

This annex provides an assessment of compliance costs, including administrative burdens, resulting from individual policy options. They are grouped in five categories according to specific objectives (see section V).

1 – Policy options to reduce overreliance on ratings

Introduction

This chapter identifies policy options that aim to reduce market overreliance on CRAs. The measures will impact the compliance costs and administrative burdens of CRAs, regulators or other stakeholders. In 2009 there were 25 CRAs[271] established in 44 locations (see Annex IV.).

Option 1 – No policy change

Under this option existing rules and corresponding administrative burdens or compliance costs remain equal.

Option 2 – Reduce reliance on external ratings by enhancing internal risk management and promoting the use of internal rating models for regulatory purposes

The requirement to *strengthen their internal risk management* requirement would ensure that financial firms (credit institutions, investment firms, insurance and reinsurance undertakings, pension funds, UCITS managers and in the future alternative investment fund managers) to assess the credit/market risk by themselves, using their own methodology.

However, the requirement to strengthen internal risk management could lead to some compliance costs. This measure would apply to all types of financial firms including credit institutions, insurance and re-insurance undertakings and investment firms.

As this measure does not entail any reporting requirement it would not entail any administrative burden. However, to conduct own internal risk managements, entities which currently do not provide for such function would need to set this up in their organisation. For others which already perform internal risk management this would require only limited additional efforts or would remain business ass usual.

Currently, while there is limited information on which institutions already perform such a risk management, it can be assumed that the majority of institutions already apply internal risk management to some extent. However, for those institutions which do not have such a function in place, the additional effort would be proportionate to the risks to which they are exposed. Some other would need to enhance their efforts to perform the internal risk assessment.

In respect to the use of internal rating models for the calculation of regulatory capital requirements, a distinction is made between (A) financial firms with material and complex risk exposures which would be required to use internal models for the calculation of regulatory capital, and (B) financial firms which will be allowed to continue to use the "standardised approach" based on external ratings which would need to complement this with assessment of the inherent credit risk of an exposure and where appropriate reflect this in the capital requirement.

[271] Impact Assessment Accompanying document to 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) 289 final, dated 2.6.2010.

A. Financial firms with material and complex[272] credit risk exposure would be required to develop and use internal rating models rather than using the standard approach, which relies on external ratings.

In this context, the key variable to identify compliance costs relates to the identification of material and complex credit risk exposures which would be defined on the basis of specific technical guidelines. Such an assessment would be attributed to the supervisory authorities such as the European Banking Authority (EBA). This assessment would be subject to a specific cost-benefit analysis.

As the material and complex credit risk exposures has not yet been determined by the regulatory authorities through a technical standard the number of the amount of financial firms which would be subject to this requirement is currently uncertain. As a result, a detailed assessment of the compliance costs of administrative burdens would be premature.

As a preliminary qualitative assessment, one could consider that for those institutions impacted by this new rule, the additional effort would most likely be proportionate to the risks to which they are exposed. For those institutions which currently rely solely on ratings, they would need to design internal rating models. For some institutions, this could require to set up a new risk management department to determine these models and apply them for their risk exposures. For these institutions, the additional workload would be material. Other institutions which already today perform partly or fully such assessments, would be only minor affected. A more detailed assessment would need to be conducted by EBA to design the detailed technical standard.

B. Those financial firms allowed to use the "standardised approach" based on external ratings for calculating their regulatory capital requirements would need to assess if the inherent credit risk of an exposure is significantly higher than the one that corresponds to the capital requirement assigned under the "standard approach" based on external ratings (or the absence thereof). They would be required to reflect if there would be a higher degree of credit risk in their evaluation of their overall capital adequacy. This requirement could lead to some further compliance costs for institutions which currently do not assess the credit risk of their exposures.

- For large financial institutions, it can be assume they perform such an assessment and therefore can be considered business as usual. It can be assumed that these entities would have the most material part of exposures.
- For smaller financial firms which do not necessary assess the credit risk of an exposure would most likely need to introduce this activity. The magnitude of the cost related to introducing this activity would most likely be proportionate to the size and magnitude of the risk exposures themselves. Small firms with extensive exposures would most likely face material compliance costs proportionate to the risk of this activity. This could include setting up an internal service to perform such an activity. Small financial firms without material credit exposures would face limited compliance costs or no costs at all.

As there is a lack of date on risk exposures which would be covered under this option, a quantitative assessment remains beyond the scope of this analysis.

Option 3 - Require credit institutions, investment firms, insurance and reinsurance undertakings to use more than one rating (if available)

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[272] A good proxy for large or complex exposures is exposures of "large or sophisticated institutions" for a sectoral legislation where entities are mainly exposed to credit risk (e.g. banking sector). This would also allow applying the proportionality principle in sectors where credit risk is usually not the predominant risk of large or sophisticated entities (e.g. insurers). Finally, this would also capture the pending developments on complex exposures such as securitisation that are being discussed in Basel.

This option would require credit institutions, investment firms, insurance and reinsurance undertakings to use at least two credit ratings issued by different CRAs, where available. These ratings would be required to be used for the calculation of capital requirements under the standardized approach.

As this option would require financial firms using the standardized approach for the calculation of capital requirements to identify if there is more then one rating available when calculating capital requirements.

This option is not expected to generate any additional administrative burden as this does not entail any new reporting requirements for parties involved. This option could however result in some very limited compliance cost to check availability and use of alternative ratings when available.

As ratings are published by CRAs under the issuers pays model, and are therefore mainly free of charge available to issuers this option are limited to additional searching cost to identify if there are more then one rating available. Furthermore, financial firms might be required to adapt their process for calculating capital requirements to take into account a second rating. As search costs are limited and ratings freely available compliance costs are considered not material.

Overall, there are 8,094 relevant financial institutions in total of which 6,458 Credit institutions and 1,636 insurance companies. Those institutions using "standardised approach" based on external ratings would need to research 2 ratings instead of 1 rating to determining their capital requirements. However as explained above, it can be assumed this is not a time-consuming change in the process of determining capital requirements under the "standardized approach".

Option 4 – Improve disclosure requirements for issuers of structured finance products on an ongoing basis

Under this option, all issuers of structured finance products would be required on an ongoing basis to disclose main elements of underlying asset pools for structured finance products necessary for investors to make their own credit assessment and not rely on external ratings. Issuers could disclose this information by means of a website.

Compliance cost and administrative burden:

This option would entail some compliance cost to set up a system to disclose information and an ongoing cost to update information periodically. It can be plausibly assumed that the information on structured finance products that needs to be disclosed is available at the issuer to some extent, particularly as this information is communicated to CRAs for obtaining a credit rating.

To set up a system to comply with disclosure requirements to issuers of a structured finance instruments or their related third parties would face a one-off cost. These costs would be related to the information disclosure and consist of a one-off investment in information systems (website) development and compliance procedures. In order to quantify the one-off costs for the relevant structured finance issuers, we made the following assumptions:

(1) According to our estimates there are approximately 125 EU-wide issuers [273] of structured finance instruments and related third parties.

[273] Extraction made from Securitisation data on all securities issued worldwide backed by EU collateral for the year 2010, Association for Financial Market in Europe (AFME), Securities Industry and Financial Market Association (SIFMA) and European Securitisation Forum (ESF).

(2) The Commission Services estimated that it would take an issuer approximately 300 hours[274] to develop a website, as well as procedures to disclose the information This would result in a total one-off hour burden of 37,500 hours for 125 EU-wide issuers.

(3) The average hourly cost for a Compliance Manager is 53€ and the average hourly cost for a Programmer Analyst is 40€. Therefore, the average one-time cost to an issuer would be (150 hours × 53€) + (150 hours × 40€) = € 13,950.

For these reasons, the Commission estimated that the average one-off administrative burden to each issuer would be € 13,950 and the total aggregate one-off administrative burden to the industry would be € 1.7 million (13,950€ x 125 issuers).

The main part of the on-going costs would be related to the issuer's or related third party's obligations to place on a website all the information on an on-going basis that is necessary for investors to make their own credit assessment. In order to quantify the on-going costs for the relevant structured finance issuers, we made the following assumptions:

(1) Based on the data[275] used by the US Securities and Exchange Commission (SEC) which proposed a similar measure (SEC rule 17g-5), the Commission estimated that each issuer or its related third party would on average disclose information with respect to approximately 125 transactions on an on-going basis and that the information would have to be updated on a monthly basis to allow investors to make and monitor their own credit assessment.

(2) The Commission Services estimated an average of 125 on-going transactions each month and 30 minutes spent on the monthly disclosure for each transaction, that each issuer would spend approximately 750 hours [125 transactions × 30 minutes × 12 months = 45,000 minutes/60 minutes = 750 hours] on an annual basis disclosing information consistent with the representations to be made for a total aggregate annual burden of 93,750 hours [750 x 125 issuers = 93,750].

(3) The average hourly cost for a Webmaster is 20€. Therefore, the average annual cost to an issuer would be 750 hours × 20€ = 15,000€.

The Commission Services estimated that the average annual administrative burden to an issuer would be 15,000€ and the total administrative burden to the industry would be € 1.9 million (15,000€ x 125 issuers).

2 – Policy options to mitigate the risks of contagion effects from sovereign debt ratings

Option 1 - No policy change

Under this option existing rules and corresponding administrative burdens or compliance costs would remain the same.

Option 2 - Require CRAs to publish a full research report on sovereign debt ratings and allocation of staff

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274 Based on the data used by the US Securities and Exchange Commission (SEC) when they proposed a similar measure under the US rule 17g-5, we estimated that it would take an issuer or related third party approximately 300 hours to develop an information system (website), as well as policies and procedures to disclose the information. It is estimated that this would entail 150 hours for a Compliance Manager and 150 hours for a Programmer Analyst.

275 Federal Register N°74, Securities and Exchange Commission, 17 CFR Parts 240, 243 and 249b Amendments to Rules for Nationally Recognized Statistical Rating Organisations; Proposed Rules for Nationally Recognized Statistical Rating Organisations; Final Rule and Proposed Rule, 12/2009. Available from: http://www.sec.gov/rules/final/2009/34-61050fr.pdf.

CRAs already today design a full research report which is made available to subscribers of this information in combination with other research data provide by CRAs. Making this report available to all stakeholders would lead to negligible administrative burden of €13,000 (€520 per CRA): 8 hours x €65 hourly rate x 25 rating agencies.

Due to making these report public CRAs will lose income from the sale of these reports to subscribers. The following assumptions are made:

- 6 CRAs currently provide sovereign debt ratings: 3 CRAs provide ratings for approximately 120 countries; 3 CRAs provide ratings for approximately 40 countries;
- The sales price of a full research report on sovereign debt ratings is estimated at 1,500 US$ per report (1 US$ = 0.723 EUR: €1,085);
- For each CRA only a limited number of reports per country are sold separately each year. This is assumed to be an average of 10 reports per year.

Based on the above mentioned assumptions, this option could lead to a loss of income for CRAs estimated at €5,208,000 per year. This is €868,000 per CRA (3 large CRAs x 120 Sovereigns rated x 10 reports/sovereign x €1,085; 3 small CRAs x 40 Sovereigns rated x 10 reports/sovereign x €1,085).

Option 3 - Require CRAs to publish sovereign ratings after closing of EU trading venues

This option would not increase administrative burden or other compliance costs as only the timing of publication is modified.

Option 4 - Require CRAs to conduct the sovereign debt ratings process more frequently

This option would lead to additional compliance costs for the CRAs. Reducing the time period for regular review of a rating (whether sovereign or not) means that the CRA has to undertake the full review process in order to determine ratings based according to the methodologies and the quality expected. In order to quantify the substantive costs for relevant CRAs the following assumptions can be made:

- The CRAs time spent on each review will stay the same. The extra workload to perform the full rating process is estimated at 100 hours. This includes: analysis (40 hours), committee meeting, including preparation by committee members (40 hours); preparation of the new rating for publication (20 hours).
- There will be one additional full rating process per year.
- The hourly rate of employee of a CRA is estimated at €65.
- The amount of analytical work required is not determined by the size of the country being analysed.
- There are 6 CRAs providing sovereign debt ratings: 3 larger CRAs provide ratings for approximately 120 countries; 3 smaller CRAs provide ratings for approximately 40 countries.

Based on the above mentioned assumptions, the substantive additional compliance costs for 6 CRAs arising out of this option are estimated at €3,120,000 per year (3 large CRAs x 120 sovereign ratings x 100 hours/rating x €65 hourly rate= €2,340,000; 3 small CRAs x 40 sovereign ratings x 100 hours/rating x €65 hourly rate = €780,000)

The substantive costs per entity are estimated at €780,000 per year for large CRAs, and €260,000 per year for smaller CRAs.

Option 5 - Extend powers of competent authorities (ESMA) to scrutinize rating methodologies

As rating methodologies are not frequently revised, compliances costs for this option are difficult to estimate. For the purpose of this impact assessment costs, following assumptions were made:

- On average rating methodology changes once every 2 years for CRAs. Designing and updating rating methodologies is a business as usual cost for rating agencies.
- Additional costs to verify rating methodology would require 50 working hours per CRA per year
- 25 CRAs could be affected by methodological changes, which would be checked once every year.
- Revision by ESMA would entail a workload of 1 full time equivalent per year for all rating agencies which is equivalent to 220 working hours

This option would not increase administrative burdens. Compliance costs are estimated at €150,550. Verification cost for CRAs would amount to €81,250 (25 rating agencies x 50 working hours x €65 hourly cost; verification costs incurred by ESMA are estimated at €69m300 (220 working days x 7 hours x €45 hourly cost).

Option 6 - Require (EU) sovereigns to publish a standardized data set on economic performance to improve credit risk assessment

This option would not lead to administrative burden for enterprises. However it would entail compliance costs for sovereigns to republish this already available information.

Following assumptions can be made to determine compliance costs for sovereigns:

- All EU sovereigns would be subject to this requirement.
- The information to be published is currently available by sovereigns.
- The information would be published on an existing website of the sovereign.
- Hourly rate is assumed to be €45.
- It is assumed that this publication would be quarterly and entail 20 working hours.

The compliance cost for sovereign issuers would amount to €108,000 per year (30 Sovereigns (European Economic Area EEA) x 4 times per year x 20 working hours x €45 hourly rate).

Option 7 - Grant ESMA the power to restrict or ban temporarily sovereign debt ratings in situations defined by the Regulation

This option could give the ESMA the power to temporarily restrict or ban sovereign debt ratings in certain exceptional situations where there exist risks of financial stability. Exercising this power would lead to compliance costs, but since an action to ban ratings is expected to be rare; the related compliance costs are estimated nil.

Option 8 - Encourage an existing, independent EU structure or a brand new European Credit Rating Agency to issue credit ratings

This option would involve substantial compliance costs in adapting an existing EU structure suitable for issuing credit ratings. This would include compliance costs to set up, develop and maintain rating issuance by this EU structure. These annual costs are estimated at €13,500,000 to 24,300,000 (equivalent to the staff level; see Annex IX for more detailed analysis).

Option 9 - Prohibit sovereign debt ratings

This option would prohibit sovereign debt ratings and would require issuers and investors to develop and use their internal models to assess credit risks. This approach would entail significant costs. Since the option is clearly not seen as cost-effective, the more précised calculations are not made. However, roughly one could estimate that for issuers and investors, the costs should be similar to ones estimated under option 3.

3 – Policy options to improve credit rating market conditions

Option 1 - No policy change

Under this option existing rules and corresponding administrative burdens or compliance costs would remain the same. The CRAs will continue to reach abnormal profit margins, which between 2008 and 2010 stayed within a range of 33% - 46% (see annex IV).

If effective, policy measure to increase competition could achieve significant savings for stakeholders, primarily issuers. On the assumption that improved competition reduces operating profit margins of biggest 3 CRAs to 30% and on the basis of 2008 – 2010 operating profit margins and revenues presented in annex IV, this would lead to annual savings of almost $489 million (€340 million) to business and investors. Assuming that 30% of revenues come from Europe and that the profits are distributed proportionally across the regions, increased competition would lead to €102 million in annual savings to European stakeholders. Whereas if more competitive environment would lead to a decrease in the biggest 3 operating profit margins to 20%, this would end up *ceteris paribus* with 173€ million in annual savings to European businesses and investors.

Option 2 - Encourage the emergence of a network of small and medium sized rating agencies

This option is not expected to generate any reporting requirements and consequently, does not generate any additional administrative burden. However, the creation of a network of SME rating agencies will create other substantial compliance costs.

Based on the recent public consultations and discussions with stakeholders, 15 European CRAs may participate in such a network in the medium term (5 years).

Based on calculations of external experts and depending on the level of integration, the indicative costs could for the establishment and operation of a network could be the following:

- One time investment cost: €3-5 million (mostly in IT to develop a database of best practices and underlying data to perform credit ratings; website)
- Annual operation cost: €1-3 million (own staff up to 30 in 5 years)
- (optional) annual training cost (analysts, advisors, investors): €3-5 million

The compliance costs are expected to be substantial and estimated to be in range between €3 to 5 million as an initial setup costs and between €800,000 to 1,600,000 as annual recurring costs. No significant administrative costs are foreseen.

Option 3 - Encourage the emergence of a new European rating agency

The costs necessary to set up and maintain such an agency are substantial. These costs amount to €300-500 million over a period of 5 years. This estimation is based on a staff level of 350 up to 1000 to develop and issue ratings depending on the number of asset classes to be covered by the agency. Depending on the financing model, these costs would need to be born fully or partly by the private sector or subject to a loan or financing by the public sector during the start-up phase during the first 3 up to 5 years (see annex X for more detailed analysis of costs).

Option 4 - Harmonise ratings scales to improve comparability of ratings between CRAs

Harmonisation of the rating scales would imply compliance costs, since rating agencies would need to determine a mapping between the existing rating scales and the new harmonised scales. Also users of ratings, including issuers and investors could face some limited compliance cost to adapt to the new harmonised scales (e.g. the costs of changing IT systems).

In order to quantify the compliance costs the following assumptions are made:

- There will be mainly one-off costs;
- The standardisation is with respect to main rating scales used for sovereign debt ratings, corporate ratings and structured finance products ratings
- The common standard(s) to be used shall be determined by a technical standard established by the European Commission or by the European Securities and Markets Authority (ESMA), rather than CRAs.
- The costs would include training of staff concerning the new ratings, informing clients about the new system, validation of the scale with the competent authority (ESMA).
- It is estimated that 25 different CRAs would need to adapt rating scales.
- The hourly tariff of employees is set to € 65
- It is estimated that the 3 main large rating agencies have around 1,200 employees. All the other rating agencies together have 500 employees. 70% of employees would require training. Therefore, 2.870 analysts have to follow a training of 2 hours to understand new rating scales.
- Each rating agency would spend € 25,000 to inform their clients.

Compliance cost to design and implement rating scales are estimated at €1,079,350, of which adaptation costs €81,250 (25 agencies x 50 hours to adapt scales x €65 per hour), education & training €373,100 (2,870 analysts to be trained x 2 hours x €65 per hour), information of investors & issuers on the website, which is considered administrative burden €625,000 (25 CRAs x €25,000 information cost).

Option 5 - Establish a European Rating Index (EURIX)

This option would lead to administrative burden as all rating agencies would be required to report any change of rating to ESMA. The creation of a European Rating Index (EURIX) would incur the following substantial compliance costs:

- a database of ratings and their publication on a dedicated website. Setting up such a database and website is expected to cost €300,000 and entail an annual maintenance costs of €75,000 (which entail the cost of one full time equivalent to monitor the database and website). The EURIX could be an extension of the central repository provided for in article 11.2 of the CRA regulation. Therefore, such a cost could be covered by the existing ESMA budget which provides for IT investments;
- Updating of data into the database would be directly performed by rating agencies. Daily update of ratings by rating agencies would require one hour of work per CRA. This would amount to the total cost of €357,500 (25 rating agencies x 220 working days x 1 hour x hourly cost of €65).

Option 6 - Require CRAs to issue joint ratings at the level of the rating committee

Under this option, small and larger CRAs would be required to work together in order to issue a joint credit rating.

The compliance costs in issuing credit rating jointly by two credit rating agencies could roughly amount to 10% of overall costs incurred in issuing credit ratings.[276] There will be no additional administrative burdens from this requirement.

Option 7 - Ban large CRAs from acquiring small and medium-sized CRAs

Under this option, the larger CRAs would not be allowed to acquire small and medium-sized CRAs. This option will not lead to administrative burden as it will not entail any additional reporting obligations.

Option 8 - Introduce temporary market share ceilings for CRAs

Under this option, the larger CRAs would introduce market ceilings for CRAs. To ensure that ESMA can verify compliance with this option, CRAs would be required to periodically, once a year) to provide information on market volume and fees to ESMA in their annual transparency report. Based on this, ESMA could evaluate market share and evaluate implementation of this option.

Based on the above information, the annual administrative burden resulting from this option is estimated at €13,000 (8 hours x €65 hourly rate x 25 rating agencies) and an annual compliance cost of €4,500 incurred by ESMA (4 hours x €45 hourly rate x 25 rating agencies).

Option 9 - Require CRAs to disclose pricing of ratings and ensure that prices are not discriminatory and based on costs

Since CRAs possess information on the pricing and the actual fees received from individual clients, this option would not require CRAs to undertake administrative activities other than providing detailed information on fees to ESMA and publishing the summary in aggregated format information on fees and actual pricing on the CRA's website, which should not exceed 16 man-hours /year /CRA. The hourly tariff of employees is set to € 65. It is expected that there should be no more than 25 CRAs concerned.

Based on the above information, the total cost of administrative burden for CRAs from disclosure of fees is estimated at €26,000 per year (16 working hours x €65 hourly rate x 25 rating agencies).

4 – Policy options to ensure the right of redress of investors

The proposed options on civil liability of CRAs do not place any further burden on CRAs or market participants in terms of administrative costs or burden. However, the increased opportunities for investors to recover their losses from CRAs will result in increased costs for CRAs. To continue as a going concern, CRAs would need to insure their civil liability or, in the absence of the insurability, to create a financial buffer to cover potential claims from investors. The exact impact on the costs is difficult to quantify, but are likely to be significant.

5 – Policy options to reinforce independence of credit rating agencies and improve ratings quality

Option 1 – No policy change

Under this option existing rules and corresponding administrative burdens or compliance costs remain the same.

276 The analogy has been made with joint audits as required in France.

Option 2 – Require institutional investors to obtain their own ratings before they can purchase a particular financial instrument

Under this option, an issuer would remain free to hire a CRA of its own choice, but each institutional investor would be required to obtain its own independent rating before investing in a particular structured finance product for amounts above certain thresholds (e.g. for clients who may be treated as professionals and where the investment portfolio exceeds EUR 500,000[277]).

In order to quantify the compliance costs for the relevant financial institutions for this option, we made the following assumptions:

- The Commission Services estimates that there should be approximately 973 new structured finance deals per year[278] in the EU market.
- We assumed that all investments in new structured finance deals in the EU would be made exclusively by institutional investors.
- We assumed that an average rating price for structured finance instrument is € 200,000.
- There is no business as usual costs.

Based on the above assumptions, the compliance costs for this option are estimated at € 194,600,000 per year (973 x 200,000). None of this is to be considered as "business as usual costs".

Option 3 – Require trading venues to set up and ensure the administration of the "Trading venues pay" model

Under this option, trading venues would be required to ensure and organise for the rating of their listed / traded companies / instruments. In the case of non-listed companies / instruments the "subscriber / investor pays" model could apply. The platform would be required to organise the rating of the pool of loans by one of CRAs. CRA to rate an instrument would be selected on the basis of objective criteria.

In order to quantify the compliance costs for the relevant stakeholders for this option, we made the following assumptions:

- We assume that under "trading venues pay" model the credit rating price would decrease by 5%.
- Turnover of the big 3 CRAs is $5.3 billion (around €3.8 billion). Smaller rating agencies together have an estimated turnover of €500 million. Total turnover would be around € 4.3 billion.
- The total turnover should be adjusted because:

[277] The investment portfolio size refers to professionals in all investment services and activities and financial instruments as defined in Annex II, Professional Clients, II.1, "the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500.000", Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L0039, 28.04.2006.

[278] Commission Services estimated 973 new structured finance deals per year in the EU market. Extraction made from Securitisation Data Base on all securities issued worldwide backed by EU collateral for the year 2010, Association for Financial Market in Europe (AFME), Securities Industry and Financial Market Association (SIFMA) and European Securitisation Forum (ESF).

- o the EU-turnover in the total turnover is estimated at 25% (€ 4.3 billion x 25% = € 1.075 billion).
- o the part of the total ratings admitted by trading venues is estimated at one-third (€ 1.075 billion x 1/3 = € 358 million).

- We assumed that one extra annual report per trading venue is necessary and also trading venues have to interact with CRAs. This is estimated at one employee's time for one year (1,800 hours) per trading venue. The hourly tariff of employees is set to € 45.
- The total number of trading venues is estimated of 219 (92 Regulated Markets and 127 MTFs).

On one hand, based on the above assumptions the costs of ratings via trading venues are lower. The reduction is estimated at €17,916,667 (€358 million x 5%). This is a loss of income for CRAs. On the other hand, there are extra costs because of one employee's work per year per trading venue € 17,739,000 (1,800 hours x € 45 x 219).

Option 4 – Require CRA selection to be undertaken by an independent board

In order to quantify the administrative costs for the relevant CRAs for this option, we made the following assumptions:

- The Commission Services estimated that there are approximately 125 EU-wide issuers there should be approximately 973 new structured finance deals per year.[279]
- Currently CRAs total turnover would be of around € 4.3 billion and the EU-turnover in the total turnover is estimated 25% of total.
- CRAs earn on average 30% of their revenue from structured finance ratings.
- We assume that this policy option could lead to an average decrease of credit rating price by 5%. A potential economy would be of € 16.1 million (€ 4.3 billion x 25% x 30% x 5%).
- We assumed an annual budget of an independent "Credit Rating Agencies Board" to ensure its proper functioning could be financed by fees resulting from credit rating price decrease, as mentioned above.

Option 5 - Introduce rotation rules for the CRAs engaged by an issuer to rate its own products and to rate the issuer itself and introduce mandatory separation between them

Under this option, the requirements would be:

- It is applicable only to solicited ratings;
- Issuer's own credit worthiness should not be rated by the same CRA for more than 3 consecutive years;
- Another CRA should take over thereafter and the outgoing CRA and the issuer should make available all information accessed in the rating process, and hand over appropriately to the incoming CRA to enable it to perform ratings effectively;
- A CRA shall not rate more than 5 consecutive issues of any asset class by the same issuer. After a CRA has rated 5 consecutive issues for an issuer, that issuer must solicit any ratings for at least its 5 following issues from a different CRA or CRAs;

[279] See policy options to reduce overreliance on external credit ratings.

- If fewer than 5 issues are made, a CRA shall not rate the issues of one issuer over a period exceeding 3 years. After 3 years have passed or 5 issues have been made, whichever is sooner, the issuer can solicit ratings from the first CRA again;
- A CRA shall not simultaneously rate an issuer and its products;
- CRAs should only rate products for which it has the capacity to rate in compliance with the CRA Regulation;
- All solicited ratings and all assets classes (corporates, structured finance instruments and sovereigns) will be concerned. The rated entities and the issuers of finance instruments would be required to comply with the rotation rules and ensure the monitoring and reporting.

In order to quantify the administrative costs for the relevant stakeholders for this option, we made the following assumptions:

- We assume that rating administration for all entities or products rated by solicited CRAs are business as usual.
- We also assume that reporting administrative burden for the industry to the regulators/national competent authorities would be entirely compensated by a lower price of competing CRA.
- We assume that the regulators/national competent authorities will be required to disclose quarterly compliance reporting to ESMA. We estimate that reporting disclosure information will take 2 hours.
- In order to calculate the administrative burden, we use the hourly wages[280] of managers in EU Member States (see table below).

Estimates for reporting to ESMA on-going costs:

[280] The hourly wages are based on standardised ESTAT data (the four-yearly labour cost survey and the annual updates of labour costs (ALC) statistics), reflecting 2006 figures. They already contain the standard 25% overhead costs, as required by the Standard Cost Model for administrative burden measurement.

Member State	Hourly wage of managers (1)	Reporting disclosure cost/year (2)=(1)*2*4
Austria	51,53	412
Belgium	50,63	405
Bulgaria	3,3	26
Cyprus	31,64	253
Czech Republic	11,52	92
Denmark	51,99	416
Estonia	8,1	65
Finland	44,75	358
France	51,14	409
Germany	46,4	371
Greece	26,98	216
Hungary	11,66	93
Ireland	49,56	396
Italy	61,5	492
Latvia	5,86	47
Lithuania	7,38	59
Luxembourg	56,63	453
Malta	16,67	133
Netherlands	36,88	295
Poland	13,02	104
Portugal	31	248
Romania	9,73	78
Slovakia	7,83	63
Slovenia	18,34	147
Spain	37,11	297
Sweden	50,8	406
United Kingdom	52,81	422
TOTAL		**6.758**

Based on the above mentioned assumptions, the on-going costs from this option are estimated at € 6,758 per year.

Option 6 – Introduce specific requirements on CRAs' independence and objectivity in relation to their shareholders

Introduce specific requirements on CRAs independence and objectivity related to their shareholders. Under this option, ESMA would be required to ensure that CRAs cannot issue ratings for any firm that holds shares in that CRA, even indirectly[281]; and that a firm that has a shareholding in a CRA should not be allowed to invest in products rated by this CRA.[282]

This option will incur only administrative burdens to CRAs in the provision of information to ESMA. In order to quantify the administrative costs for the CRAs for this option, we made the following assumptions:

- The Commission services estimates that there are 25 registered CRAs in the EU.
- We assumed that CRA will be requested to fill an annual compliance report to ESMA related to their shareholders and at any time to inform ESMA when a substantial change was incurred under this option.

[281] The CRA Regulation already includes a specific provision (see Section B, 3.b) related to the operational requirements under which a CRA is prohibited from issuing ratings in certain circumstances. However, the provision does not contain a specific reference to shareholders and no clear definition of "control".

[282] This option is in line with existing company law and free movement of capital provisions.

- The Commission services estimated that the preparation of annual compliance report would take approximately 4 hours.
- The hourly tariff of employees is set to € 65.

Based on the above mentioned assumptions, the costs from this option are estimated at € 6,500 *(25 CRAs x 4 hours x € 65)* per year.

Option 7 - Strengthen rules on disclosure of rating methodologies

Under this option the existing rules on rating methodologies will be strengthened by (1) extending the requirement to disclose methodologies and underlying assumptions behind ratings from structured finance products to all asset classes, (2) enhancing the requirement to disclose material changes in methodologies by additionally requiring the publication of clear reasoning and justification for the changes and (3) enhancing the requirement to disclose errors in methodologies or their application by requiring immediate disclosure directly to the affected parties including investors, issuers and competent authorities.

In order to quantify the administrative costs for the relevant financial institutions for this option, we made the following assumptions:

- Sub-option (1) extending the requirement to disclose methodologies and underlying assumptions behind ratings from structured finance products to all asset classes:
    a) The Commission Services estimated that there are 25 registered CRAs in the EU.
    b) CRAs earn on average 30% of their revenue from structured finance ratings.
- Sub-option (2) enhancing the requirement to disclose material changes in methodologies by additionally requiring the publication of clear reasoning and justification for the changes.
- Sub-option (3) enhancing the requirement to disclose errors in methodologies or their application by requiring immediate disclosure directly to the affected parties including investors, issuers and competent authorities.

Strengthened rules on the disclosure of rating methodologies in relation to structured finance products will entail costs for CRA in publishing such information. However since this information will be already available to CRA, the administrative burdens from disclosing this information will be negligible.

Option 8 – Require CRAs to inform issuers sufficiently in advance of the publication of a rating

Under this option the disclosure procedural[283] requirements for solicited and unsolicited ratings will be strengthened. CRAs will be required – sufficiently in advance of the publication of the rating – to inform issuers of the principle grounds on which the rating is based. This could also include a requirement to elaborate on the main assumptions which justify the change of rating and would apply both to solicited and unsolicited ratings. As only the timing of information changes, this option is expected not to entail any substantial additional administrative burdens or other compliance costs.

[283] This option would extend the current requirement of 12 hours, provided for in Annex I D (3) which does not reflect the working hours available to perform an assessment.

ANNEX XIII. COHERENCE WITH MAIN LEGISLATIVE INITIATIVES

A Comprehensive strategy to restore Financial Stability to underpin Sustainable Growth in the EU

As soon as the crisis broke in 2007, the EU acted promptly adopting a series of urgent measures to prevent the crisis spreading and limit its extent and impact. In particular the focus was on coordinating the European economic stimulus package to promote recovery, applying the state aid regime firmly but flexibly so as to avoid distortions of competition while allowing banks to restructure, and increasing the amounts guaranteed by Deposit Guarantee Schemes (DGSs) up to €100,000 per account.

Following this wave of "emergency" measures, the Commission launched a programme of reforms which implements the commitments taken by the G20 and aims at tackling more structural issues in the EU financial sector and address the main sources of its vulnerability as unveiled by the crisis:

- The low levels of high quality capital and insufficient liquidity in the banking sector, partly reflecting inadequate and pro-cyclical prudential requirements and failures in risk assessment and management;
- Supervisory shortcomings, particularly with regard to the supervision of individual institutions operating in a cross-border context and to the unregulated financial sector;
- Corporate governance failures which contributed to excessive risk taking practices in financial institutions;
- Insufficient market transparency and inadequate disclosure of information to the authorities including supervisors, particularly with reference to complex structured financial products;
- Lack of adequate regulation and supervision of Credit Rating Agencies;
- Insufficient macro prudential surveillance of the financial sector as a whole to prevent macro-systemic risks of contagion;
- The absence of a harmonised framework to facilitate the orderly wind-down of banks and financial institutions which has contributed to put pressure on Member States to inject public money into banks to prevent a general collapse

The building blocks of this programme were illustrated in the Communication of 4 March 2009, Driving European Recovery, and the Communication of 2 June 2010 'Regulating financial services for sustainable growth" which set out the details of the financial reform package.

The first elements were put in place in the period 2009-2010. The most important is represented by the new architecture for financial supervision which involved the establishment of the European Systemic Risk Board, which will ensure that macro-prudential and macro-economic risks are detected at an early stage, and three new European Supervisory Authorities responsible for banking (European Banking Authority or EBA), insurance (.European Insurance and Occupational Pensions Authority or EIOPA) and securities markets (European Securities Markets Authority ESMA) to ensure reinforced supervision and better co-ordination among supervisors.

An important gap in regulation has been plugged through the Regulations on credit rating agencies ('CRA I' and 'CRA II') introducing strict authorisation requirements and supervision

for CRAs, and entrusting ESMA with the supervision on CRAs. Moreover the Capital Requirements Directive (CRD) was amended ('CRD III') to reinforce capital rules for the trading book and for complex derivatives and to introduce binding rules on remuneration and bonuses in financial institutions. A further regulatory and supervisory gap has been plugged with the Directive on managers of alternative investment funds, including hedge funds (AIFM Directive) providing robust and harmonised regulatory standards for all managers and enhancing transparency towards investors.

The interplay between the persisting fragilities of the financial sector, particularly due to the funding conditions for the banking sector, and pressures on governments' public finance and sovereign debt markets, the so called twin crisis', became of mounting source of concern in the end of 2010 and during the first half of 2011.

In order to tackle effectively the twin crisis and to restore the EU economy to sustainable long term growth, the Commission and Member States have developed a coordinated and gradual approach to address both dimensions, i.e. the structural fragilities of the financial sector and the vulnerabilities of sovereign markets, in parallel. This requires bringing to completion the on-going reform programme to achieve a healthier financial sector along a series of measures to deliver a new quality of economic policy coordination to reduce the contagion risks from the vulnerable Member States to other sovereign markets and ensure public-debt sustainability.

The first component is articulated along three dimensions:

I. Improving stability and governance of financial institutions

Improved stability of financial institutions will be achieved through the new European Supervisory Authorities which will coordinate the work of national supervisors, ensuring coherent supervisory practices and contributing to the establishment of a common rulebook for financial institutions. In July 2011, the Capital Requirements Directive (CRD) was revised again in order to implement the “Basel III” agreement, which significantly increases the levels of capital which banks and investment firms must hold to cover their risk-weighted assets. The proposal includes provisions to improve risk control and oversight as well as enhance supervisory review of risk governance in financial institutions.

At the end of 2011, a new legislative proposal on CRAs ('CRA III') will tackle further risks related to the functioning of the rating business, such as the "issuer-pays" model, the overreliance on ratings, the lack of competition in the sector, and the specificities of sovereign debt. In that respect the initiative will contribute also to reducing the pressure on sovereign markets.

A proposal for a review of the Directive of financial conglomerates has been adopted to simplify and clarify the Directive with respect to a number of current problems (inadequacy of thresholds, complexity of supervisory tools etc.), and harmonize its application.

The publication of the results of the 2011 EU-wide stress test, based on stricter requirements, better coordination and peer review and a significantly higher degree of transparency, will provide the right incentives for banks to restructure their operations, strengthen their capital base, and regain viability. Coordinated back-stop measures, with market based recapitalisation in the first place, will be set-up to take remedial action for banks failing the stress test. In last resort case of public interventions, the EU State aid rules will provide the appropriate framework to ensure financial stability and a level playing field.

Market conditions permitting, new State Aid control measures based on Article 107(3)(c) TFEU will be introduced as of 1 January 2012 with a gradual tightening of conditions towards a new permanent State Aid Regime. The continuation of the crisis regime under Article

107(3)(b) could be envisaged for those Member States that would be subject to a macroeconomic adjustment programme accompanying financial assistance

The legislative proposal for a new EU bank resolution regime will establish a series of legal arrangements that allow the relevant authorities to more easily restructure or resolve a distressed credit institution without recourse to public financial support. The new regime will include certain tools ("bail-in") to ensure that the objective of making shareholders and creditors of the credit institutions contribute to the restructuring and resolution of the banks. The approach of increasing market discipline by clearly setting the rules for burden sharing between public and private sector in crisis situation will be a common element also in the State aid framework and in the European Stability Mechanism created for the sovereign, which foresees some private sector involvement.

II. Enhancing efficiency, integrity, liquidity and transparency of markets

The review of the Markets in Financial Instruments Directive (MiFID) will improve transparency, efficiency and integrity of securities markets in several ways. For example, the scope of MiFID will be extended to new types of trading platform and financial products, thus removing some opaque areas of securities markets. Some derogations will be also removed, and transparency requirements will be extended to all kinds of securities, not just shares.

The Market Abuse Directive (MAD) will also be revised to provide for a more effective prevention, detection and sanctioning of market abuses.

A Regulation has been proposed on Over-The-Counter (OTC) derivatives markets implementing the G20 commitment that standardised OTC derivative transactions be cleared via central counterparties (CCPs). If a party to a transaction fails in mid-transaction, the existence of a CCP would remove the risk and uncertainty as to whether the transaction will be completed. A further obligation for OTC derivatives to be registered in trade repositories, with access for supervisors in the EU, will provide a better overview of who owes what and to whom and to detect any potential problems, such as accumulation of risk, early on.

A proposed Regulation regarding short selling and Credit Default Swaps (CDSs) will increase transparency via a requirement for flagging of short orders on trading venues, and notification or disclosure of significant short positions relating to shares and sovereign debt (including through the use of CDSs). This will enable supervisors to detect when such transactions are reaching dangerous levels and consider intervention on markets.

Further security will be provided by a planned Securities Law Directive (SLD), which will ensure that intermediaries always posses the securities which they maintain for the account of their customers. In addition, envisaged legislation on Central Securities Depositories (CSDs) will further secure the post trading handling of securities till their final settlement.

III. Achieving a greater protection and inclusion of consumers and investors

The Commission has brought forward proposals to reform Deposit Guarantee Schemes (DGS) and Investor Compensation Schemes (ICS), on top of recently agreed increase of the guaranteed amount (to € 100,000 under DGS, € 50,000 under ICS). The proposed revised Directives include improved payout times, better funding of schemes, and a proposal for interlinkages and a mutual support mechanism between schemes (both deposit guarantee and investor compensation), to ensure that schemes in difficulties do not fail, to the detriment of consumers.

A legislative proposal on fair practices relating to mortgage credits will improve the way in which mortgages are sold to consumers, analogous to existing obligations in place for

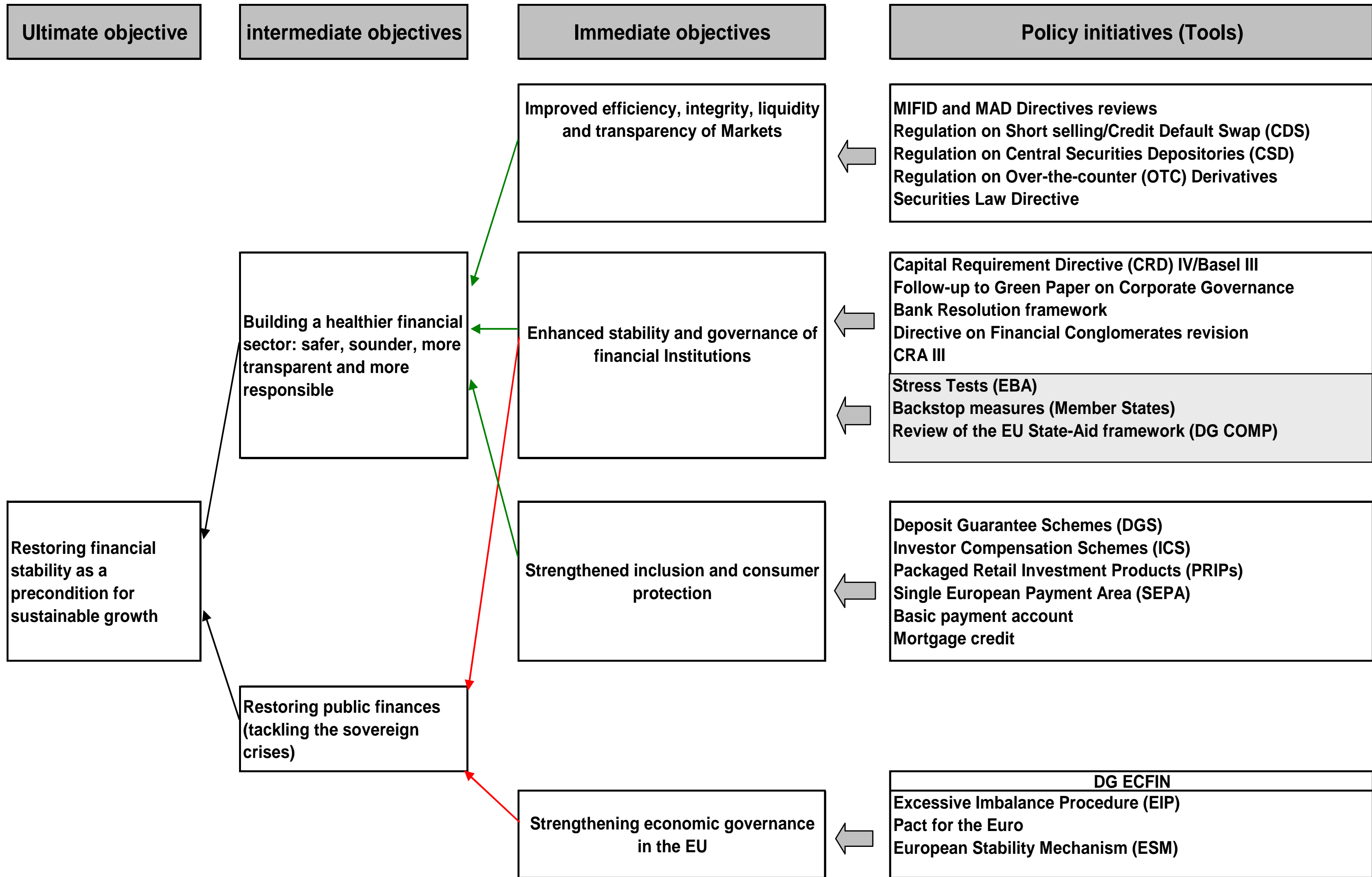
consumer credit; and ensure that all mortgage lenders and intermediaries are properly regulated and supervised.

The Commission has proposed a Regulation setting an end-date for the completion of the Single European Payments Area (SEPA) for direct debits and credit transfers to speed up the process that will make payments all over the Euro zone as easy and quick as domestic payments.

For packaged retail investment products (PRIPs), a proposal is planned to make sure that all consumers in Europe will in the future be able to get short, focused, and plainly-worded information about investments in a common format, with risks and costs made much clearer and easier to understand, aiding comparisons. In addition, EU rules governing those selling the products will be made more consistent and standardised where necessary.

To enhance financial inclusion the Commission will table a proposal to ensure EU citizens might have access to a basic bank account with electronic payment instruments.

On a macro-financial level, the positive impact on public debt sustainability of these initiatives will be backed by implementing the decisions taken by the European Council in March 2011 on delivering a new quality of economic policy coordination through reinforced economic governance, including the excessive imbalance procedure (EIP), the "Pact for the Euro" and the new European Stability Mechanism (ESM).


Ultimate objective
intermediate objectives
Immediate objectives
Policy initiatives (Tools)
Improved efficiency, integrity, liquidity and transparency of Markets
MIFID and MAD Directives reviews
Regulation on Short selling/Credit Default Swap (CDS)
Regulation on Central Securities Depositories (CSD)
Regulation on Over-the-counter (OTC) Derivatives
Securities Law Directive
Building a healthier financial sector: safer, sounder, more transparent and more responsible
Enhanced stability and governance of financial Institutions
Capital Requirement Directive (CRD) IV/Basel III
Follow-up to Green Paper on Corporate Governance
Bank Resolution framework
Directive on Financial Conglomerates revision
CRA III
Stress Tests (EBA)
Backstop measures (Member States)
Review of the EU State-Aid framework (DG COMP)
Restoring financial stability as a precondition for sustainable growth
Strengthened inclusion and consumer protection
Deposit Guarantee Schemes (DGS)
Investor Compensation Schemes (ICS)
Packaged Retail Investment Products (PRIPs)
Single European Payment Area (SEPA)
Basic payment account
Mortgage credit
Restoring public finances (tackling the sovereign crises)
Strengthening economic governance in the EU
DG ECFIN
Excessive Imbalance Procedure (EIP)
Pact for the Euro
European Stability Mechanism (ESM)

ANNEX XIV – ADDITIONAL TECHNICAL CHANGES

The European Commission will also suggest some technical clarifications for which no major impacts are expected:

Clarification which requirements apply to rating outlooks

Rating outlooks are opinions issued by CRAs regarding the likely direction of a credit rating over the short and medium term. The relevance of credit outlooks for investors and issuers and their effects on markets are comparable to the effects of any "normal" rating decision. Therefore, also the procedural requirements of the CRA Regulation which aim at ensuring that ratings are accurate and understood by investors should apply.

A definition of rating outlooks should be added and it should be specified which requirements of the CRA Regulation apply to rating outlooks. Even if under current supervisory practice some of the requirements in the Regulation already apply to rating outlooks, the introduction of a definition for rating outlooks and the clarification which specific provisions apply to outlooks will clarify the rules and provide legal certainty.

Application of certain reporting and disclosure obligations to certified credit rating agencies

It should be clarified that the requirement according to Article 11 (2) of the CRA Regulation which obliges credit rating agencies to make available in a central repository established by ESMA information on its historical performance also applies to certified credit rating agencies. This understanding is justified because ratings issued by certified CRAs may be used for regulatory purposes by investors in the same way as investors use ratings issued by registered CRAs. Including performance data from certified CRAs in the central repository allows investors to compare their performance (in comparison with other certified or registered CRAs). This understanding is shared by ESMA, national competent authorities and credit rating agencies.

It should also be clarified that certified CRAs have a regular reporting obligation to ESMA. Even if certified CRAs are supervised primarily by the supervisory authority of the third country where they are established, in accordance with third country rules that have been considered equivalent to the EU CRA Regulation, ESMA should have the right to request information from certified credit rating agencies. This understanding is suggested by ESMA's role in the certification process according to Article 5 of the CRA Regulation which refers to a role in ongoing supervision (to verify that the conditions for initial certification are continuously met). This understanding is shared by ESMA, national competent authorities and credit rating agencies.

ANNEX XV. MEASURES AGAINST OVER-RELIANCE ON EXTERNAL CREDIT RATINGS IN CRDIV

The following should provide you with an overview of what we do about reliance on ratings in CRD IV.

First, the most problematic overreliance on ratings takes place when banks invest in rated securities without understanding the risks of these securities. Misguided investment decisions may create bubbles. The worst of this problem, in the field of securitisation, has already been addressed by CRD II. That directive required banks to carry out a range of analysis for their securitisation investments, even if they are AAA rated.

Beyond securitisation, CRD IV will also require that banks' investment decisions must never rely solely and mechanistically on ratings but always form their own internal credit opinion on every exposure.

Distinct from the banks' internal reliance on ratings, there is the calculation of regulatory capital requirements according to the Basel II framework and hence, the CRD. Capital requirements are meant to be risk-sensitive and therefore require measures of credit risk as inputs.

Avoiding overreliance in this field does not mean making no references to rating whatsoever. References to ratings may still be the best available policy alternative in some instances. For instance, as an option for banks, the CRD also allows the use of internal ratings for calculating capital requirements. However, the necessary systems are costly to implement and to supervise. In some instances, developing internal ratings may be outright impossible (when there is a limited number of material counterparties the bank has, for instance).

The compromise that it was therefore to propose with CRD IV is to require banks with a material number of exposures in a given portfolio (be it sovereigns, banks, or corporates) to develop internal ratings for that portfolio. In other words, a clear preference was expressed for using internal rather than external ratings where possible. This requirement on the bank is without prejudice to the decision of the supervisors to validate the rating system and allow its use for calculating capital requirements. The notion of "materiality" in that context would still have to be defined by delegated act, trying to find the right balance in order not to overburden smaller institutions.

CRD IV will however also require (smaller) banks that do not use internal ratings to compare their internal credit opinion (as opposed to a more formal and validated rating system) to the capital requirement resulting from an external rating. If the internal assessment shows that for a given loan, the external rating and the resulting capital requirement are too favourable compared to the internal credit opinion, the bank will be required under Pillar 2 to hold additional capital.

In addition, CRD IV will require EBA to survey:

- to what extent banks internally rely on external ratings;
- what progress is made across the banking sector in implementing internal ratings for capital requirements purposes;
- to what extent other national legislating (ie not implementing the CRD) relies on ratings.

ANNEX XVI. GLOSSARY

Term	Explanation
ABS (Asset Backed Security)	An Asset Backed Security is a security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets which can be for instance mortgage or credit cards credits.
AIFMD (Alternative Investment Fund Managers Directive)	The Alternative Investment Fund Managers Directive created a comprehensive and effective regulatory and supervisory framework for managers of hedge funds and private equity funds in the European Union.
Asset write down	An asset write down recognises that an asset's value has fallen by reflecting this new, lower value in accounting treatment.
Barrier to entry	A barrier to entry is an obstacle to entering a particular market. Barriers to entry could include regulatory requirements or competing large, well-established existing market players.
Basel II	Basel II is the second Basel Accord issued by the BCBS (see separate entry), which is a series of recommendations on banking supervision and regulation. The aim of the Accord was to produce an internationally recognised standard approach to the amount of capital that banks should hold.
Basel III	Basel III is the third Basel accord, currently being developed, by the BCBS (see separate entry), which will propose a further series of standards on capital and liquidity for banking supervision and regulation.
BCBS (Basel Committee on Banking Supervision)	The BCBS is an institution created by the Governors of the central banks of the Group of Ten nations. It was created in 1974 and meets on a quarterly basis.
CDO (Collateralised Debt Obligation)	A collateralised debt obligation is a type of asset backed security in which the assets are debt obligations (see ABS).
CDS (Credit Default Swap)	A credit default swap is a contract between a buyer and a seller of protection to pay out in the case that another party (not involved in the swap), defaults on its obligations. CDS can be described as a sort of insurance where the purchaser of the CDS owns the debt that the instrument protects; however, it is not necessary for the purchaser to own the underlying debt that is insured.
CESR (Committee of European Securities Regulators)	CESR was the predecessor body to ESMA. See ESMA.
"cliff" effects	"cliff" effect refers to a positive feedback loop, where downgrading a single security can have a disproportionate cascading effect. This has become pronounced with respect to the assessment of credit risk in a bank's portfolio. If a Credit Rating Agency has the expectation that the credit risk of a position rises, it will downgrade its rating. As a consequence, a bank faces additional capital charges in order to comply with national capital requirements.
CMBS (Commercial Mortgage Backed Security)	A commercial mortgage backed security is a type of asset backed security for which the assets are commercial mortgages (see ABS).
Contagion effect	Financial contagion refers to a scenario in which small shocks, which initially affect only a few financial institutions or a particular region of an economy, spread to the rest of financial sectors and other countries whose economies were previously healthy, in a manner similar to the transmission of a medical disease. Financial contagion happens at both the international level and the domestic level. At the domestic level, usually the failure of a domestic bank or financial intermediary triggers transmission when it defaults on interbank

Term	Explanation
	liabilities and sells assets in a fire sale, thereby undermining confidence in similar banks.
CRD (Capital Requirements Directive)	Directives 2006/48/EC and 2006/49/EC. These Directives establishe the authorisation and pursuit of business of credit institutions along with the principle of single passport and home country control and further sets out the applicable prudential requirements: supervision and disclosure by competent authorities, consolidated supervision, capital requirements, reporting of and limits to large exposures and non-financial holdings, suitability of managers and shareholders, standards for the internal risk management and public disclosure to achieve market discipline. It introduced Basel II accord in the EU legislation.
CRD IV	CRD IV is an amendment to the CRD that introduces the Basel III accord in EU legislation, creates a single rule book for banks and transfers certain part of the CRD to a Regulation.
Credit risk	Credit risk is the risk that a borrower will default on a debt, i.e. not repay the debt. This can also be called default risk.
Credit write down	A credit write down is where the value of a debt is reduced and the new, lower value is recognised (See write down).
Dodd-Frank Wall Street Reform and Consumer Protection Act	An Act in 2010 was introduced to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.
Due diligence	Due diligence in this impact assessment generally refers to a process of investigation and verification before making an investment.
EBA (European Banking Authority)	The EBA is the successor organisation to the Committee of European Banking Supervisors (CEBS), and was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010. It is one of the three European Supervisory Authorities (ESAs); see also ESMA and EIOPA.
ECAF (Eurosystem Credit Assessment Framework)	The Eurosystem credit assessment framework (ECAF) defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met. The framework takes into account credit information assessments from four sources
ECAI (External Credit Assessment Institution)	CRAs recognised by national supervisors to determine the risk-weights on their rated credit exposures (including securitisation exposures) under the Basel II Framework, the standardised approach to credit risk requires banks to use credit assessments provided by External Credit Assessment Institutions (ECAIs) recognised by national supervisors to determine the risk-weights on their rated credit exposures (including securitisation exposures). National supervisors are responsible for determining whether an ECAI meets the eligibility criteria set out in the Framework, so that banks incorporated in their jurisdictions can use the ECAI's risk assessment for the calculation of the capital requirement under Basel II.
ECB (European Central Bank)	The European Central Bank is the central bank of the Euro currency, based in Frankfurt in Germany. The ECB's primary role is to maintain price stability in the EU.

Term	Explanation
EEA (European Economic Area)	The Agreement creating the European Economic Area (EEA) entered into force on 1 January 1994. It allows the EEA European Free Trade Association (EFTA) States Norway, Iceland and Liechtenstein (Switzerland has not joined) to participate in the Internal Market on the basis that they adopt all EU single market legislation except that relating to agriculture and fisheries.
ESM (European Stability Mechanism) [51]	The European Stability Mechanism (ESM) is a permanent rescue funding programme to succeed the temporary European Financial Stability Facility and European Financial Stabilisation Mechanism. The European Stability Mechanism (ESM) is due to be launched in mid-2013.
EIOPA (European Insurance and Occupational Pensions Authority)	The European Insurance and Occupational Pensions Authority replaced the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). It is established under EU Regulation 1094/2010.
EMEA (Europe, Middle East and Africa)	The abbreviation EMEA designates the geographic region of Europe, the Middle East and Africa.
ESMA (European Securities Markets Authority)	ESMA is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA). More information on ESMA can be found at www.esma.europa.eu.
Euro Debt Crisis	This refers to the budgetary and funding difficulties facing parts of the EU following the first part of the financial crisis.
EUROSTAT	Eurostat is a Luxembourg-based Directorate-General of the European Commission with the main task of providing the European Union with Europe-wide statistical information.
FSB (Financial Stability Board)	The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. It was established after the 2009 G-20 London summit in April 2009 as a successor to the Financial Stability Forum. The Board includes all G-20 major economies, FSF members, and the European Commission. It is based in Basel, Switzerland.
G20	The Group of Twenty Finance Ministers and Central Bank Governors is a group of finance ministers and central bank governors from 20 major economies: 19 countries plus the European Union.
Herd behaviour	A tendency of market participants to conform in their behaviour with that of their peers
IMF (International Monetary Fund)	The International Monetary Fund (IMF) is an intergovernmental organization that oversees the global financial system by taking part in the macroeconomic policies of its established members, in particular those with an impact on exchange rate and the balance of payments.
Investor-pays model	The investor-pays model is a model which was formerly used by CRAs and which is no longer in widespread use. Under this model, investors (often in groups) paid for credit ratings rather than the currently prevalent issuer-pays model (see separate entry).
IORP (Institutions for Occupational Retirement Provision)	Institutions for Occupational Retirement Provision Directive 2003/41/EC is a European Union Directive designed to create an internal market for occupational retirement provision. It lays down minimum standards on funding pension schemes, the types of investments pensions may make and permits cross-border management of pension plans.
IRB (Internal Ratings Based)	Advanced approach by which a bank can use its own credit

Term	Explanation
model	assessments to calculate its regulatory capital requirements for credit risk. Depending on the risk factors the bank is allowed to estimate, a distinction is made between a foundation IRB and an advanced IRB approach
Issuer-pays model	The currently prevalent model under which issuers pay CRAs directly to be rated or for their issuances to be rated.
Junk status	Junk status refers to a level of credit rating at which an instrument is no longer considered to be 'investment grade'.
Liquidity	Liquidity is a complex concept that is used to qualify market and instruments traded on these markets. It aims at reflecting how easy or difficult it is to buy or sell an asset, usually without affecting the price significantly. Liquidity is a function of both volume and volatility. Liquidity is positively correlated to volume and negatively correlated to volatility. A stock is said to be liquid if an investor can move a high volume in or out of the market without materially moving the price of that stock. If the stock price moves in response to investment or disinvestments, the stock becomes more volatile.
Lock-in effect	The lock-in effect refers to the difficulty for issuers to change the CRA they are using for a rating.
Market concentration	Market concentration is a term, referring to a way of measuring the relationship between the number of firms in a market and their respective share of it. In a more concentrated market, fewer firms will have a larger market share; in a less concentrated market, a greater number of firms will have smaller market share.
Market risk	Market risk is the risk of losses due to price fluctuations of financial instruments in the trading book
MiFID (Markets in Financial Instruments Directive)	Directive 2004/39/EC that lays down rules for the authorisation and organisation of investment firms, the structure of markets and trading venues, and the investor protection regarding financial securities.
NCB (National Central Bank)	A national central bank is a public institution that is normally tasked with issuing currency, controlling supply of money and setting interest rates.
NRSRO (Nationally Recognized Statistical Ratings Organisation)	NRSRO is a designation by the United States Securities and Exchange Commission that enables a CRA's ratings to be used for regulatory purposes.
Oligopoly	An oligopoly is a market which is dominated by only a few large and dominant players. Oligopolies can be characterised by low differentiation between market participants, high barriers to entry and high profits over a long period.
Procyclicality	Procyclicality refers to the tendency to increase the effect of variations in the economic cycle. This is often applied to something that increases the effect of a negative economic impact, such as "cliff" effects.
Prospectus Directive	Directive 2003/71/EC of the European parliament and of the Council, which lays down rules for information to be made publicly available when offering financial instruments to the public.
Public utility model	The model which would require transforming the credit rating agency into a public utility and funding it with government revenues.
QIS5 (Five Quantitative Impact Studies)	In order to assess its impact the development of "Solvency II" was accompanied by five Quantitative Impact Studies. In these studies insurance and reinsurance undertakings as well as insurance groups under the scope of "Solvency II" determine their eligible own funds and capital requirements according to preliminary specifications of the new rules.
Rating downgrade	A rating downgrade refers to a credit rating being revised by a CRA to a lower rating.

Term	Explanation
Rating upgrade	A rating upgrade refers to a credit rating being revised by a CRA to a higher rating.
Ratings action	A ratings action means a review of a credit rating leading to a change. This might be a rating upgrade or downgrade (see separate entries) or another action such as placing on positive or negative watch (a status of review while the CRA is deciding whether or not to upgrade or downgrade), or even affirming the current rating.
Ratings and Securitisation working group	A working group established by the Basel Committee to review the Basel framework's reliance on ratings
RMBS (Retail Mortgage Backed Security)	A retail mortgage backed security is a type of ABS (see separate entry) in which the assets are retail mortgages.
SEC (Securities and Exchange Commission)	The US regulatory body responsible for the regulation of securities and protection of investors.
SME (Small to Medium Enterprise)	On 6 May 2003 the Commission adopted Recommendation 2003/361/EC regarding the Small and medium sized enterprise definition. While 'micro' sized enterprises have fewer than 10 employees, small have less than 50, and medium have less than 250. There are also other criteria relating to turnover or balance sheet total that can be applied more flexibly.
Solicited rating	A rating requested by the issuer or another party.
Solvency II	The Solvency II Directive 2009/138/EC is an EU Directive that codifies and harmonises the EU insurance regulation. Primary this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency.
Sovereign debt	Sovereign debt (also known as government debt or public debt) refers in this impact assessment to money that a central government borrows. The debt is usually raised by the government issuing bonds by auction.
Spill-over effects	Spillover effects are externalities of economic activity or processes those who are not directly involved in it.
Spread (bond spread, CDS spread, yield spread)	The difference between the bid and the ask price of a security or asset.
SPV (Special Purpose Vehicle)	A special purpose vehicle (also called special purpose entity) is a legal entity that is set up to fulfil a specific purpose. SPVs are widely used in the creation of ABS, in which the assets will be held by an SPV set up with the purpose of owning those assets and receiving and distributing income streams from them. In this sense, SPVs are usually distinct from the legal entities that create them (so that its creditors have no claim over the assets of the SPV).
Standardised approach	The standardised approach to credit risk and the standardised approach to market risk are methods of assigning credit risk weightings to assets for regulatory capital calculation purposes, proposed by the Basel Committee on Banking Supervision.
Structured finance product	A structured finance product, also known as a market-linked product, is generally a pre-packaged investment strategy based on derivatives, such as a single security, a basket of securities, options, indices, commodities, debt issuance and/or foreign currencies, and to a lesser extent, swaps.
Subprime mortgage	Subprime mortgages are those lent to parties who have limited or impaired credit history or a lower ability to repay the loan. They usually carry a higher interest rate to reflect the increased risk.
Subsriber pays model	A model under which payment for ratings is made by investors subscribing to a service, rather than the issuer (see entry for issuer pays model).
Systemic	Systemic, in this impact assessment, describes the quality of having an significant impact across the whole financial system.
TFEU (Treaty on the Functioning of the European	Primary source of EU law, together with the TEU (Treaty on the European Union), as modified by the "Treaty of Lisbon amending the

Term	Explanation
Union)	Treaty on European Union and the Treaty establishing the European Community", signed at Lisbon, 13 December 2007.
UCITS (Undertakings for Collective Investments in Transferable Securities)	Undertakings for Collective Investment in Transferable Securities Directives, a standardised and regulated type of asset pooling.
Unsolicited rating	A rating issued without being requested by an issuer.
Volatility	Volatility refers to the change in value of an instrument in a period of time. This includes rises and falls in value, and shows how far away from the current price the value could change, usually expressed as a percentage.
WBS (Whole Business Securitisation)	A whole business securitisation is a type of ABS in which the assets are a business. This is typically used by a parent company transferring a portion of its revenue-generating assets to an SPV (see separate entry), which in turn uses the revenue to loan funds to the parent company.
Working Group on Liquidity	The Working Group on Liquidity is a working group that reports to the Policy Development Group of the Bank for International Settlement's Basel Committee on Banking Supervision (see http://www.bis.org/bcbs/). The Policy Development Group is one of the Committee's four main sub-committees. The Working Group on Liquidity has published a set of standards for liquidity management and supervision (see http://www.bis.org/publ/bcbs144.htm).
Yield spread	The yield spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.