Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (Text with EEA relevance)

REGULATION (EU) No 462/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

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THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Central Bank[(1)],

Having regard to the opinion of the European Economic and Social Committee[(2)],

Acting in accordance with the ordinary legislative procedure[(3)],

Whereas:

(1) Regulation (EC) No 1060/2009 of the European Parliament and of the Council[(4)] requires credit rating agencies to comply with rules of conduct in order to mitigate possible conflicts of interest, and to ensure high quality and sufficient transparency of credit ratings and the rating process. Following the amendments introduced by Regulation (EU) No 513/2011 of the European Parliament and of the Council[(5)], the European Supervisory Authority (European Securities and Markets Authority) (ESMA), established by Regulation (EU) No 1095/2010 of the European Parliament and of the Council[(6)], has been empowered to register and supervise credit rating agencies. This Regulation complements the current regulatory framework for credit rating agencies. Some of the most important issues, such as conflicts of interest due to the issuer-pays model and disclosure for structured finance instruments, have been addressed and the framework will need to be reviewed after having been in place for a reasonable period of time to assess whether it fully resolves those issues. Meanwhile the need to review transparency, procedural requirements and the timing of publication specifically for sovereign ratings was highlighted by the current sovereign debt crisis.

(2) The European Parliament's resolution of 8 June 2011 on credit rating agencies: future perspectives[(7)], called for enhanced regulation of credit rating agencies. At its informal meeting of 30 September and 1 October 2010, the Ecofin Council acknowledged that further efforts should be made to address a number of issues related to credit rating

activities, including the risk of over-reliance on credit ratings and the risk of conflicts of interest stemming from the remuneration model of credit rating agencies. The European Council of 23 October 2011 concluded that progress is needed on reducing over-reliance on credit ratings.

(3) At the international level, the Financial Stability Board (FSB), of which the European Central Bank (ECB) is a member institution, endorsed on 20 October 2010 principles to reduce the reliance of authorities and of financial institutions on credit ratings ('the FSB principles'). The FSB principles were endorsed by the G20 Seoul Summit in November 2010. It is therefore appropriate that the sectoral competent authorities assess market participants' practices and encourage those market participants to mitigate the impact of such practices. The sectoral competent authorities should decide upon the measures for encouragement. ESMA, where appropriate in cooperation with the European Supervisory Authority (European Banking Authority), established by Regulation (EU) No 1093/2010 of the European Parliament and of the Council[(8)], and with the European Supervisory Authority (European Insurance and Occupational Pensions Authority), established by Regulation (EU) No 1094/2010 of the European Parliament and of the Council[(9)], should take action to facilitate convergence of supervisory practices in accordance with Regulation (EU) No 1095/2010, and within the framework of this Regulation.

(4) Credit rating agencies should make investors aware of the data on the probability of default of credit ratings and rating outlooks based on historical performance, as published on the central repository created by ESMA.

(5) Pursuant to the FSB principles, 'central banks should reach their own credit judgments 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'. Furthermore, the ECB stated in its opinion of 2 April 2012 that it is committed to supporting the common objective of reducing over-reliance on credit ratings. In that respect, the ECB reports regularly on the various measures taken by the Eurosystem to reduce reliance on credit ratings. Pursuant to Article 284(3) of the Treaty on the Functioning of the European Union (TFEU), the ECB is to address an annual report on the activities of the European System of Central Banks (ESCB) and on the monetary policy of both the previous and current years to the European Parliament, the Council and the Commission, and also to the European Council. The President of the ECB is to present that report to the European Parliament, which may hold a general debate on that basis, and to the Council. Further, the ECB could, in such reports, describe how it has implemented the FSB principles and the alternative assessment mechanisms it uses.

(6) The Union is working towards reviewing, at a first stage, whether any references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on such credit ratings and, at a second stage, all references to credit ratings for regulatory purposes with a view to deleting them by 2020, provided that appropriate alternatives to credit risk assessment are identified and implemented.

(7) The relevance of rating outlooks for investors and issuers and their effects on markets are comparable to the relevance and effects of credit ratings. Therefore, all the requirements of Regulation (EC) No 1060/2009 which aim at ensuring that rating actions are accurate, transparent and free from conflicts of interest should also apply to rating outlooks. According to current supervisory practice, a number of requirements of that Regulation apply to rating outlooks. This Regulation should clarify the rules and provide legal certainty by introducing a definition of rating outlooks and clarifying which specific provisions apply to such rating outlooks. The definition of rating outlooks should also encompass opinions regarding the likely direction of a credit rating in the short term, commonly referred to as credit watches.

(8) In the medium term, further action should be evaluated to delete references to credit ratings for regulatory purposes from financial regulation and to eliminate the risk-weighting of assets by means of credit ratings. However, for the time being, credit rating agencies are important participants in the financial markets. As a consequence, the independence and integrity of credit rating agencies and their credit rating activities are of particular importance in guaranteeing their credibility vis-à-vis market participants, in particular investors and other users of credit ratings. Regulation (EC) No 1060/2009 provides that credit rating agencies are to be registered and supervised as their services have considerable impact on the public interest. Credit ratings, unlike investment research, are not mere opinions about a value or a price for a financial instrument or a financial obligation. Credit rating agencies are not mere financial analysts or investment advisors. Credit ratings have regulatory value for regulated investors, such as credit institutions, insurance companies and other institutional investors. Although the incentives to rely excessively on credit ratings are being reduced, credit ratings still drive investment choices, in particular because of information asymmetries and for efficiency purposes. In that context, credit rating agencies must be independent and must be perceived as such by market participants, and their rating methods must be transparent and be perceived as such.

(9) Over-reliance on credit ratings should be reduced and all the automatic effects deriving from credit ratings should be gradually eliminated. Credit institutions and investment firms should be encouraged to put in place internal procedures in order to make their own credit risk assessment and should encourage investors to perform a due diligence exercise. Within that framework, this Regulation provides that financial institutions should not solely or mechanistically rely on credit ratings. Therefore, those institutions should avoid entering into contracts where they solely or mechanistically rely on credit ratings and should avoid using them in contracts as the only parameter to assess the creditworthiness of investments or to decide whether to invest or divest.

(10) Regulation (EC) No 1060/2009 already provided a first round of measures to address the question of independence and integrity of credit rating agencies and their credit rating activities. The objectives of guaranteeing the independence of credit rating agencies and of identifying, managing and, to the extent possible, avoiding any conflicts of interest that could arise were already underpinning several provisions of that Regulation. The selection and remuneration of the credit rating agency by the rated entity (the issuer-

pays model) engenders inherent conflicts of interest. Under that model, there are incentives for credit rating agencies to issue complacency ratings on the issuer in order to secure a long-standing business relationship in order to guarantee revenues or to secure additional work and revenues. Moreover, relationships between the shareholders of credit rating agencies and the rated entities may cause conflicts of interest, which are not sufficiently dealt with by the existing rules. As a result, credit ratings issued under the issuer-pays model may be perceived as the credit ratings that suit the issuer rather than the credit ratings needed by the investor. It is essential to reinforce the conditions of independence applying to credit rating agencies in order to increase the level of credibility of credit ratings issued under the issuer-pays model.

(11) In order to increase competition in a market that has been dominated by three credit rating agencies, measures should be taken to encourage the use of smaller credit rating agencies. It has been the practice in recent times for issuers or related third parties to seek credit ratings from two or more credit rating agencies, and therefore, where two or more credit ratings are sought, the issuer or a related third party should consider appointing at least one credit rating agency which does not have more than 10 % of the total market share and which could be evaluated by the issuer or a related third party as capable of rating the relevant issuance or entity.

(12) The credit rating market shows that, traditionally, credit rating agencies and rated entities enter into long-lasting relationships. This raises the risk of familiarity, as the credit rating agency may become too sympathetic to the desires of the rated entity. In those circumstances, the impartiality of credit rating agencies could, over time, become questionable. Indeed, credit rating agencies appointed and paid by a corporate issuer have an incentive to issue overly favourable ratings on that rated entity or on its debt instruments in order to maintain the business relationship with such issuer. Issuers are also subject to incentives that favour long-lasting relationships, such as the lock-in effect whereby an issuer refrains from changing credit rating agency as this could raise concerns of investors regarding the issuer's creditworthiness. This problem was already identified in Regulation (EC) No 1060/2009, which required credit rating agencies to apply a rotation mechanism providing for gradual changes in analytical teams and credit rating committees so that the independence of the rating analysts and persons approving credit ratings would not be compromised. The success of those rules, however, was highly dependent on a behavioural solution internal to the credit rating agency, namely the actual independence and professionalism of the employees of the credit rating agency vis-à-vis the commercial interests of the credit rating agency itself. Those rules were not designed to provide a sufficient guarantee towards third parties that the conflicts of interest arising from the long-lasting relationship would effectively be mitigated or avoided. A way to achieve this could be by limiting the period during which a credit rating agency can continuously provide credit ratings on the same issuer or its debt instruments. Setting out a maximum duration of the contractual relationship between the issuer which is rated or which issued the rated debt instruments and the credit rating agency should remove the incentive for issuing favourable credit ratings with respect to that issuer. Additionally, requiring the rotation of credit rating agencies as a normal and regular market practice should also effectively mitigate the problem

of the lock-in effect. Finally, the rotation of credit rating agencies should have positive effects on the credit rating market, as it would facilitate new market entries and offer existing credit rating agencies the opportunity to extend their business to new areas.

(13) It is, however, important that the implementation of a rotation mechanism is designed in such a way that the benefits of the mechanism more than outweigh its possible negative consequences. For example, frequent rotation could result in increased costs for issuers and credit rating agencies because the cost associated with rating a new entity or financial instrument is typically higher than the cost of monitoring a credit rating that has already been issued. It also takes a considerable amount of time and resources to get established as a credit rating agency, whether as a niche player or covering all asset classes. Further, ongoing rotation of credit rating agencies could have a significant impact on the quality and continuity of credit ratings. Equally important, a rotation mechanism should be implemented with sufficient safeguards to allow the market to adapt gradually before possibly enhancing the mechanism in the future. This could be achieved by limiting the scope of the mechanism to re-securitisations, which is a limited source of bank funding, while allowing credit ratings that are already issued to continue to be monitored upon request even after rotation becomes mandatory. Thus, as a general rule, rotation should only affect new re-securitisations with underlying assets from the same originator. The Commission should review whether it is appropriate to maintain a limited rotation mechanism or to apply it to other asset classes as well and, if so, whether other classes warrant different treatment with respect to, for example, the length of the maximum duration of the contractual relationship. If the rotation mechanism is established for other asset classes, the Commission should evaluate whether it is necessary to introduce an obligation on the credit rating agency to provide, at the end of the maximum duration period of the contractual relationship, information on the issuer and on the rated financial instruments (a handover file), to the incoming credit rating agency.

(14) It is appropriate to introduce rotation on the credit rating market for re-securitisations. First, that is the segment of the European securitisations market that has underperformed since the financial crisis, and it is therefore the one in which the need to address conflicts of interest is greatest. Second, while the credit risk on debt instruments issued by, for instance, corporates to a high degree depends on the debt servicing capacity of the issuer itself, the credit risk on re-securitisations is generally unique to each transaction. Therefore, when a re-securitisation is created the risk of knowledge being lost by hiring a new credit rating agency is not high. In other words, although there is currently only a limited number of credit rating agencies active in the credit rating market for re-securitisations, that market is more naturally open to competition and a rotation mechanism could be a driver for creating more dynamics in that market. Finally, the credit rating market for re-securitisations is dominated by a few large credit rating agencies but there are other players who have been building up expertise in this area.

(15) Regular rotation of credit rating agencies issuing credit ratings on re-securitisations should bring more diversity to the assessment of creditworthiness. Multiple and different views, perspectives and methodologies applied by credit rating agencies should produce more diverse credit ratings and ultimately improve the assessment