



European Economic and Social Committee

ECO/280
Credit rating agencies

Brussels, 2 December 2010

OPINION

of the

Section for Economic and Monetary Union and Economic and Social Cohesion

on the

**Proposal for a Regulation of the European Parliament and of the Council on amending
Regulation (EC) No 1060/2009 on credit rating agencies**

COM(2010) 289 final – 2010/0160 (COD)

Rapporteur: **Mr Cedrone**

Administrator: Siegfried Jantscher

On 30 June and 13 July 2010 respectively, the European Parliament and the Council decided to consult the European Economic and Social Committee, under Articles 114 and 304 of the Treaty on the Functioning of the European Union, on the

Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies
COM(2010) 289 final – 2010/0160 (COD).

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 25 November 2010.

At its ... plenary session, held on ... (meeting of ...), the European Economic and Social Committee adopted the following opinion by ... votes to ... with ... abstentions.

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1. **Conclusions and recommendations**

1.1 This Opinion deals with the second phase of the Commission's three phase approach to the regulation of Credit Rating Agencies (CRAs). The Committee considers that on this issue the EU has reacted actively, not least with the proposal in question, stimulating similar reactions at international level, when faced with a crucially important issue which has caused serious damage (with no end yet in sight) to its economy, its businesses and its people. The Committee calls for this work to be pursued steadily and consistently.

1.2 The Committee also considers that swift action is needed to end the differences between the level of integration of the financial market and that of financial supervision (still in the hands of the Member States), as these differences are one of the causes of the damage suffered. The Committee therefore **welcomes** this proposal, which provides for making the ESMA¹ responsible for supervision of CRAs. The effectiveness of this will depend on adaptation of the relevant national provisions and an end to the **confusion** that still remains, going further than the current proposals as some countries have requested.

¹

European Securities Market Authority.

- 1.3 The Committee welcomes the proposals contained in Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16/09/2009 on credit rating agencies², particularly as regards basic issues; these concern transparency and conflicts of interest, information, competition and foreign rating agencies. However, while mindful of the complexity of the subject, the Committee regrets the delay in entry into force of the regulation, which should already have provided for the changes now being proposed.
- 1.4 The EESC is also concerned about the specific nature of sovereign debt and, in particular, the failure to set up a European body for assessing sovereign debt. We look forward to the outcome of the public consultation which is now under way³.
- 1.5 The Committee attaches great importance to making European subsidiaries of agencies whose parent company is outside the EU subject to the new supervision rules. In this context, the EESC welcomes the relevant provisions of the 2009 regulation. The best solution would be a G20 agreement to lay down global rules making the various jurisdictions consistent, creating international codes of conduct which all agencies should abide by, and entrusting supervision to the Financial Stability Board, which should also have the power to impose penalties, in agreement with the various countries' bodies. The EESC is pleased that this process has already been launched at the instigation of the EU.
- 1.6 The Committee considers that the reform process, which has already been launched, must be concluded more swiftly.
- 1.7 Restoring consumer and investor confidence in the financial market is vital, and this can only be achieved if people can be sure that the matter is being taken seriously, adopting strict measures to deal with "players" who do not abide by the rules.
- 1.8 Given the role played by rating agencies in the recent crisis on the securities and financial markets, the Committee welcomes the fact that a three-phase programme has been put in place to regulate the role which these agencies play on behalf of investors and consumers (see the Commission report on its public consultation on the subject). The role of the CRAs is very important for providing the requisite information and ensuring that credit operations do not incur excessive risks (in itself an important task for ensuring the stability and security of the financial markets), their credit rating activity seems more open to question when it comes to sovereign States. The EESC welcomes the inclusion of sovereign debt in the public consultation underway.
- 1.9 The reasons for looking at the oligopoly held by a few rating agencies in the assessment of risks deriving from the instruments and bonds held by investors, banks, insurance or national

² Hereinafter referred to as the 2009 regulation.

³ Public consultation on Credit Rating Agencies of 5.11.2010.

governments stem mainly from the premise that the information supplied by these agencies is a public good, so that they ultimately provide a service of general interest.

- 1.10 When rating agencies judge the financial sustainability of a sovereign State (sovereign risk), as happened recently with the downgrading of the government debt of Greece and other EU Member States which had borrowed heavily on international markets, a problem immediately arises as to whether their action is in keeping with their aims (to provide transparent and responsible information for the market) and whether there might also be a conflict of interest between private international investors (who use the rating to assess the risks of their investment activity) and the general public/consumer in the country concerned, who suffer the consequences of any declaration of the likelihood of sovereign insolvency, notwithstanding the fact that the insolvency may have been caused by shortcomings and omissions on the part of politicians.
- 1.11 Rating agencies can carry out effective rating of sovereign debt provided they have the proper instruments and methods and observe the rules laid down by the relevant public authorities.
- 1.12 The EESC believes that the rating of sovereign debt is a matter of public interest. It welcomes the public consultation which the Commission has launched and looks forward to presenting its considered opinion in due course.
- 1.13 The Committee also proposes that, in the event of delays or failure to reach agreement at international level, the case be considered for encouraging setting-up of a dedicated European agency for sovereign debt. The establishment of an authoritative European agency for ordinary credit ratings should also be encouraged, in order to help increase competition in the sector.
- 1.14 Alongside the proposal for European supervision of rating agencies, the Committee welcomes the fact that the main related issues (penalties, competition, conflicts of interest, information), have been addressed by the 2009 regulation⁴.
- 1.15 The Committee welcomes the fact that the relevant legislation reduces Member States' room for discretion. This will make it easier to exchange information and ensure consistency of different countries' legislation, to prevent the effects of European supervision being cancelled out.
- 1.16 As occurred with the reform recently approved in the United States, the Committee proposes encouraging harmonisation of national legislation protecting users of products and financial services (consumers, businesses etc.). Provision could also be made for the presence of one or more consumer representatives, chosen by the social partners and consumer associations, at

⁴ See the EESC Opinion on Credit Rating Agencies, OJ C 277/25, 17.11.2009, p. 117.

the European supervisory authorities (now the European System of Financial Supervision - ESFS).

- 1.17 The Committee proposes encouraging, in the wider sense of the term, the financial information production network, facilitating the inclusion of more players and the introduction of new rules intended to achieve more transparent, effective assessment methods, particularly as regards derivatives.
- 1.18 The Committee proposes moving on from the current system of self-regulation, also at international level. The process of coordinating the various competent authorities needs to be pursued, with strict rules to apply to all devised and the **certainty that they will be enforced**. The EU should make every effort to achieve this objective in international bodies.
- 1.19 Lastly, the Committee proposes simplifying the regulation and making it clearer so that it is easier to understand and apply; complicated rules are easier to evade.
- 1.20 The Committee calls for an end to the obligation for rating agencies to rate securities in order for them to be sold (as proposed also by the Financial Stability Board). Removing this condition for issuing securities on the market would avoid passive acceptance of financial instruments that are high risk, even if they score highly. The Committee shares the concern of the Larosière Group that the use of ratings for regulatory capital removes too much responsibility from financial institutions while at the same time embedding the CRA oligopoly. The EESC welcomes the fact that this issue forms part of the current public consultation.

2. **Introduction**

- 2.1 As is well known, the serious shortcomings in the regulation and supervision of international finance were among the underlying causes of the recent crisis. The crisis also eloquently showed the contradictions between a financial system and banking groups which operate as global companies while being regulated and forced to go under as bodies covered by domestic law (Mervyn King, Governor of the Bank of England).
- 2.2 The same is true within the Union, where the crisis has further increased the urgent need to devise a European reference framework for both regulation and supervision. Faced with an increasingly integrated financial market, we have discovered that different Member States adopt very different rules and supervisory systems.
- 2.3 The European Commission has adopted a progressive approach to the regulation of Credit Rating Agencies (CRAs). In the immediate aftermath of the banking crisis, the focus was on regulation and supervision with particular emphasis on the rating of complex derivatives and

the conflicts of interest involved. The failures in the rating of these instruments contributed materially to the crisis⁵.

- 2.4 In parallel with the legislative progress which culminated in the 2009 regulation, the findings of the Larosière group led to the decision to completely overhaul financial regulation and supervision in the EU. A proposal has since been adopted to implement a two tier supervisory framework in the EU. There are three dedicated supervisory bodies in the lower tier and one of these, ESMA (European Securities and Markets Authority), is to be responsible for the supervision of CRAs. The proposal which is the subject of the present Opinion is solely concerned with the modifications necessary to embed the powers of ESMA into the provisions of the 2009 regulation.
- 2.5 As the bank based financial crisis has been overtaken by the sovereign debt crisis, a new set of questions have arisen about the role of credit rating agencies relative, inter alia, to sovereign debt. It is possible that this further phase of activity will result in a third regulation which for the moment only exists in the form of a public consultation document dated 5/11/2010. The chapter headings give an indication of the issues involved: reliance on credit ratings for regulatory capital, sovereign debt ratings, enhancement of competition in the credit rating industry, civil liability of CRAs and potential conflicts of interest. It is to be expected that the EESC will give a considered opinion in due course on these issues in the probable context of the new regulation which has been referred to.
- 2.6 Moreover, harmonised EU rules also leave plenty of room for discretion and national options, aside from the addition of national "interpretations" during the transposition stage.
- 2.7 Larosière found that CRAs have shown serious limitations, particularly as regards complex derivatives, when the assessment methods used, the lack of information and transparency and the evident conflicts of interest are considered⁶.
- 2.8 *Furthermore, these agencies have a full scale oligopoly, since just three of them control some 90% of the credit rating market: Moody's, Standard & Poor's and Fitch, which are largely American. They played an important role in the development of the world financial and economic crisis. While the 'issuer pays' formula works reasonably well for sovereign and corporate debt, it created a major conflict of interests for the rating of complex derivative instruments, establishing an unprecedented vicious circle to the detriment of the transparency of the transactions carried out.*
- 2.9 Furthermore, these agencies have a fullscale oligopoly, given that just three of them control some 90% of the credit rating market: Moody's, Standard & Poor's and Fitch, which are

⁵ A synopsis of the 2009 regulation can be found in section 3 of the EESC Opinion on Credit Rating Agencies, OJ C 277/25, 17.11.2009, p. 117.

⁶ See the EESC Opinion on Credit Rating Agencies, OJ C 277/25 of 17.11.2009, p. 117.

largely American. They were instrumental in the unfolding of the world financial and economic crisis, and were in certain cases paid (and are still being paid) by the finance companies for which they issued or issue ratings, establishing an unprecedented vicious circle to the detriment of the transparency of the transactions carried out.

- 2.10 But as if nothing had changed, the same agencies go on issuing assessments which are not necessarily objective. Indeed, on 24 April 2010, notwithstanding the EU's commitment of EUR 110 billion for Greece, Standard & Poor's downgraded the Greek debt to the level of that of Azerbaijan.
- 2.11 It was only in the wake of these events and of criticisms from leading EU figures on the workings of the credit rating system that the European Council decided to launch the above-mentioned public consultation, which includes the issue of sovereign debt. Certain Member State governments hate the idea that markets can lay bare the mistakes and miscalculations of profligate governments, even though governments have defaulted on sovereign debt from time immemorial. In the meantime, this Opinion relates to the 2009 regulation.
- 2.12 In its Communication of 2 June 2010⁷, the Commission summed up progress to date (see appended tables) on setting up a "safer, more transparent and more responsible" European financial system, serving the real economy and society as a whole.
- 2.13 Hence the call for **centralised supervision** of the rating agencies operating in the EU, handing over responsibility to the new European System of Financial Supervision, the three European supervisory authorities, while leaving the fundamental issues related thereto to a later date.

3. **Gist of the amendments to Regulation 1060/2009**

3.1 *Subject matter, scope and definitions (Amendments to Title I)*

- 3.1.1 The key, most significant element is, as has been said, the move from supervision at national level to European supervision, with most of the **supervisory power entrusted to ESMA** in respect of agencies registered in Europe and agencies which belong to other countries but operate in Europe (European branches).
- 3.1.2 Article 4 lists managers of **alternative investment funds** in order to treat them in the same way as the other EU financial institutions with regard to the use of credit ratings. This means that where these funds use credit ratings, the ratings must have been issued by a CRA properly registered or certified under the new Regulation.

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COM(2010) 301 final: Regulating financial services for sustainable growth.

- 3.2 *Issuing of credit ratings, access to information (Amendments to Title II)*
- 3.2.1 Issuers of structured finance instruments or related third parties should be required to give **access to the information** which they have given to the CRA they are using to competing CRAs as well, which should not use it for any other purposes than for the rating. This should avoid conflicts of interest arising for the CRA paid by the issuer – the entity requesting the rating (sic) (issuer-pays model).
- 3.3 *Registration procedure and surveillance of rating activities (Amendments to Title III)*
- 3.3.1 With the introduction of the single European supervisory authority, existing provisions, which envisage a college type of supervisory coordination, are to be eliminated (abolishing colleges) in order to permit more effective oversight of CRAs operating in multiple jurisdictions. In addition ESMA may ask the Commission to regulate the registration procedure and standards on the information to be supplied. It is entitled to request information, investigate potential breaches of the regulation, conduct inspections, etc.
- 3.4 *Cooperation between ESMA and competent authorities (Amendments to Title III)*
- 3.4.1 **National authorities** keep oversight responsibility as regards the use of credit ratings by the supervised entities (such as banks, insurance or investment companies); they exchange information on CRAs, cooperate and assist ESMA.
- 3.4.2 ESMA may also delegate certain tasks to competent national authorities, including for reasons of cost. In particular, it may delegate tasks such as investigations and on-site inspections, assessment of applications for registration and any tasks related to supervision. In this connection specific guidelines should be issued by ESMA, which will retain responsibility.
- 3.5 *Penalties, committee procedure (Amendments to Title IV, Chapter I)*
- 3.5.1 ESMA may request that the Commission **impose penalties** on CRAs in order to put an end to an infringement with the issuing of a public notice, obtain information it has requested or subject a CRA to an investigation. Where the CRA has committed a breach of the regulation, ESMA may fine it, request temporary suspension of issue of new ratings, request that the infringement stop or, as a last resort, withdraw the registration.
- 3.5.2 The committee procedures have been aligned with the Lisbon Treaty.
- 3.6 *Transitional and final provisions (Amendments to Title IV, Chapter II)*
- 3.6.1 Once ESMA is operational, national authorities' powers in the area will have to be terminated. Procedures will also have to be established for transmission of documents and information by national authorities.

3.7 The Committee believes that the conclusions of the public consultation on credit rating agencies recently launched by the Commission tally with those of this Opinion. The Committee reserves the right to further explore the issues addressed by the consultation, should it be necessary.

4. **General comments**

4.1 The new Commission proposal takes the right approach as regards moving from supervision at national level to European supervision, a highly complex operation which must be more than just a collegial endeavour on the part of the Member States⁸ as proposed by the previous regulation if it is to yield satisfactory results. Moreover, the proposal follows the opportune approach already recommended by the Larosière report⁹. The regulation could be seen as a little too vague in that it does not always provide clear solutions.

4.2 However, beyond that, the current proposal does not significantly change the rules CRAs have to comply with under the previous regulation (September 2009), in order to be registered or to pursue their activities.

4.3 In any case, the most important question relates to CRAs operating outside Europe, which are not actually affected by the proposed changes: **who is really affected by the European regulation?** How can ratings issued, for example, by Moody's, Standard & Poor's and Fitch (still the CRAs with the greatest influence, despite the disasters they have caused) be neutralised? Will supervising their European branches be enough to bring their worldwide oligopoly to an end?

4.4 It is well known which are the principal CRAs operating at international level: Moody's, Standard & Poor's, Fitch ratings, Dun & Bradstreet, A. M. Best, Egan-Jones Rating Company (all US companies), Dominion Bond Rating (Canada), Baycorp Advantage (Australia), China Credit Information Service (China), Japan Credit Rating Agency (Japan), Rating Agency Malaysia (Malaysia), NKC Independent Economists (South Africa). **Where is Europe here?** The fact remains that Europe, the leading world economic power, has no CRA, not even for sovereign credit.

4.5 The Anglo-Saxon group of agencies reflect the previous dominance of Anglo-Saxon capitalism which was not disrupted by two world wars and the specific operational issues

⁸ Regulation No. 1060/2009 of the European Parliament and of the Council of 16 September 2009, on credit rating agencies.

⁹ Opinion of the European Economic and Social Committee on the following proposals: Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, COM(2009) 499 final - 2009/0140 (COD); Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority, COM(2009) 501 final - 2009/0142 (COD); Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority, COM(2009) 502 final - 2009/0143 (COD); Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority, COM(2009) 503 final - 2009/0144 (COD).

relating to Asian economies. It is surprising that no European agencies have emerged since the Common Market was established although Fitch, which is French owned, has based itself outside France. The failure of a CRA with a global reach to emerge in the EU since 1957 can be compared with the equally poor EU showing in hi-tech industries over the same period. The EU does not nurture entrepreneurs in modern industries. CRA will review competition in its consultation. The entrepreneurial deficit will need to be examined.

5. **Specific comments**

- 5.1 The Committee welcomes the creation of a European supervisory authority for the financial markets; the proposal is without a doubt a step in the right direction, gearing the financial framework more to the needs which have emerged in an attempt to restore the confidence and security of markets, individuals and businesses. However, the proposal is still insufficient to achieve its goals.
- 5.2 The proposal to have rating of alternative investment funds, if required, carried out by a registered or certified agency is also to be welcomed.
- 5.3 It is more difficult, however, to make the "issuer pays" model transparent, objective and competitive, as the system still contains a conflict of interest, yet CRAs in this situation should be prevented from issuing ratings on their members. It is encouraging that a process to standardise rules at international level has been launched, for example, as is happening in the US, Japan, etc.
- 5.4 The Committee welcomes – not least for reasons of cost - the fact that certain tasks are delegated to national authorities, provided that this is part of a clear division of responsibilities between European and national authorities. In particular, it is important to make good commitments and define measures regarding accuracy of information, registration and on-site inspections.
- 5.5 The Committee welcomes the introduction of the principle of penalties for CRAs which fail in their duties or do not respect the regulation.
- 5.6 The real challenge for policy-makers, given that we are not dealing with fresh-faced innocents here, is not just finding clear, extremely dissuasive rules but enforcing them. **Penalties** need to be laid down **for directors** and managers of the European and international market supervision authorities who fail to meet their obligations as well, given the harm that failure to act on their part causes to banks and healthy finance, as well as the economy, businesses and individuals. All they are doing is giving a great boost to speculation and all those behind it. They should at least pay a personal price for their failure to comply. The "ethics" called for by many in this period of turbulence will be hard to achieve without accountability and, therefore, penalties.

5.7 In addition, the part relating to the international aspects is not wholly adequate. Issues relating to users of financial products, both businesses and, more importantly, individuals, need to be addressed.

Brussels, 25 November 2010.

The President
of the
Section for Economic and Monetary Union and
Economic and Social Cohesion

Michael Smyth

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N.B. Appendix overleaf.

APPENDIX

to the Opinion of the Section for Economic and Monetary Union and Economic and Social Cohesion

The following amendments were rejected during the discussion but received over a quarter of the votes.

Point 1.12

Delete the first sentence:

~~"1.12 The Committee also proposes that, in the event of delays or failure to reach agreement at international level, the case be considered for encouraging setting up of a dedicated European agency for sovereign debt. The establishment of an authoritative European agency for ordinary credit ratings should also be encouraged, in order to help increase competition in the sector."~~

Reason

See the reason given for the deletion of paragraph 1.10. With regard to the second sentence, no entrepreneur other than the owner of Fitch, has come forward in the EU since 1957 to establish such an agency. It is the same failure of enterprise that we see in hi-tech industries over the same period. At the present time a new entrant in the USA is challenging the existing tripartite oligopoly.

Outcome of the vote

Votes against:	51
Votes in favour:	33
Abstentions:	0

Point 1.16

Delete this point:

~~"1.16 The Committee proposes encouraging, in the wider sense of the term, the financial information production network, facilitating the inclusion of more players and the introduction of new rules intended to achieve more transparent, effective assessment methods."~~

Reason

This is too vague to be a serious proposal to the Commission. It has little, if anything, to do with ESMA and CRA regulation.

Outcome of the vote

Votes against:	51
Votes in favour:	34
Abstentions:	3

Point 2.6

Delete this point:

~~"2.6 — But as if nothing had changed, the same agencies go on issuing assessments which are not necessarily objective. Indeed, on 24 April 2010, notwithstanding the EU's commitment of EUR 110 billion for Greece, Standard & Poor's downgraded the Greek debt to the level of that of Azerbaijan."~~

Reason

The example given does not support the thesis in the first sentence. Sovereign debt in the EU had previously carried a high credit rating in all Member States because it was assumed that the eurozone was standing behind the debts of each Member State. What the April settlement revealed was that while the eurozone was prepared to provide liquidity to help Greece to refinance its debts, it was quite unprepared to stand behind those debts. It is improbable that Greece on its own will be able to repay its debts and the S&P downgrade was a simple reflection of the fact that Greece is likely to default in due course. S&P was simply doing its job. The German government has subsequently made it known that in the event of a sovereign default in the eurozone, private sector lenders will have to accept some of the losses involved, thus highlighting the credit risk.

Outcome of the vote

Votes against:	47
Votes in favour:	30
Abstentions:	2

Point 4.3

Delete this point:

*"4.3—In any case, the most important question relates to CRAs operating outside Europe, which are not actually affected by the proposed changes: **who is really affected by the European regulation?** How can ratings issued, for example, by Moody's, Standard & Poor's and Fitch (still the CRAs with the greatest influence, despite the disasters they have caused) be neutralised? Will supervising their European branches be enough to bring their worldwide oligopoly to an end?"*

Reason

As written, this paragraph should be deleted since the CRA 1 regulation dealt precisely with the issues of ratings issued outside the EU. Such ratings must be confirmed by an EU regulated and supervised branch of the international agency. The two rhetorical questions at the end of the paragraph are out of context.

Outcome of the vote

Votes against:	41
Votes in favour:	35
Abstentions:	4
