EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON CREDIT RATING AGENCIES – EUROSYSTEM REPLY

On 5 November 2010 the Commission published a consultation paper on credit rating agencies (CRAs) with the purpose to gather views on possible future initiatives at EU level aimed at strengthening the regulatory framework related to credit rating.

The Eurosystem has a keen interest in the policy debate concerning possible measures addressed to reduce overreliance on external credit ratings, in consideration of the important effects that the perceived existence of shortcomings in the rating activity performed by CRAs may have on market confidence and the possible adverse effects on financial stability.

In addition, the Eurosystem is directly concerned with the services that rating agencies provide in the context of Eurosystem tasks and obligations with regard to both the conduct of monetary policy operations and asset management operations. In the assessment of credit standards of assets eligible for monetary policy operations, the Eurosystem takes into account, *inter alia*, credit assessments deriving from different sources, including "external credit assessment institutions" (ECAIs). These institutions are subject to general acceptance criteria, complemented by a multi-annual performance monitoring process in accordance with the conditions published in the ECB Guidelines on monetary policy instruments and procedures of the Eurosystem.[1] In this context, the Eurosystem has already expressed in various instances its views on some of the policy issues raised by the consultation paper.[2]

Against this background, this note provides the views of the Eurosystem regarding the specific questions raised by the Commission, following the order of the consultation paper (see list of questions in Annex 1). In addition, the annexes at the end of the note provide further background information on the ABS loan-level initiative (Annex 2), the ECAIs approved by the ECAF and supervisory authorities (Annex 3) and the main regulatory changes in the US with regard to CRAs due to the Dodd-Frank Act (Annex 4).

1 OVERRELIANCE ON EXTERNAL CREDIT RATINGS (QUESTIONS 1-15)

The Eurosystem supports the Commission's efforts to reduce the reliance of financial markets and the official sector on CRAs' ratings and to diminish the impact of "cliff effects" on financial institutions and markets. The crisis has shown that the overreliance on ratings, as they are embedded in many regulations and private contracts through ratings downgrades (and their spill-over effects) can destabilise financial markets. To effectively reduce this overreliance the Eurosystem agrees with the Commission's approach consisting of two main pillars: (1) requiring financial firms to undertake their own due diligence and internal credit risk assessment and (2) reducing the reliance of regulation and supervisory practices on external ratings. A comprehensive stock-taking exercise of situations where CRAs' ratings are embedded in regulations and private contracts could be developed, including the use of ratings in the collateralisation requirements of OTC derivatives transactions.

1 See the Guideline of the ECB of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7), OJ L 310, 11.12.2000, p. 1, as amended (available at www.ecb.int).

2 See the Eurosystem's contribution to the public consultation on the Commission's draft directive/regulation on credit rating agencies, September 2008, published on the ECB's website; the ECB opinions CON/2010/82 of 19 November 2010 and CON/2009/38 of 21 April 2009.

The crisis has clearly shown that for the financial firm's own survival and to preserve the broader financial stability, the basic principle that financial firms have to make their own credit assessment and due diligence of every transaction they contemplate entering should apply.[3] This in turn should ensure that financial firms should not invest or trade in any product that they do not adequately understand or of which they cannot fully assess the risks. This basic principle should always apply. As shown during the crisis, inadequate expertise and excessive reliance on third party assessments are causes of mispricings, panics, sharp sell-offs and contagion. In this context, the requirement that financial firms should conduct "own credit assessment" may be considered as a combination of internally developed credit judgment and external input with varying weights depending on the specific characteristics of the credit exposures. The supervisory focus should be put in developing rules for the appropriateness of this combination. Moreover, the quality of the (credit) risk assessment and due diligence approaches and their appropriateness given the activities of the financial firm should be subject to thorough supervisory review.

Some comments on the specific issues mentioned in the first section of the consultation paper are provided below.

1.1 USE OF EXTERNAL RATINGS FOR INTERNAL RISK MANAGEMENT PURPOSES

The Eurosystem supports efforts that lead to the use of and reliance on a broad set of credit risk indicators to assess and map credit risk. However, vigilance is required regarding measures that would replace one credit risk measure (i.e. the external rating) by a single alternative measure (e.g. a single market measure). First, hardwiring and automatic reliance on a single credit measure or single third party assessment within regulatory/supervisory and market practices should be avoided. As shown during the crisis these practices lead to forced selling, cliff-effects, severe downward spirals and contagion. These negative events could also materialise if ratings would be replaced by an alternative single measure. Second, credit risk can hardly be captured by one single measure; multiple measures and careful analysis is required to assess and reflect the credit risk of a transaction or investment.

Additionally, the Eurosystem is cautious against any automatic reliance of regulation on market based variables. Market-based information may be excessively volatile and significantly misleading, for instance, during times of market dislocation. In these situations, market information can be procyclical; reflecting over- or under- reactions which result in mispricing over longer time periods.

As regards sovereign-risk ratings, internal capabilities to assess sovereign risk should also be developed in the general investment framework and credit risk assessment of a financial firm, which should also include the distribution of exposures across several countries. While most of the information needed to access sovereign default risk is publicly available, a financial firm needs to develop adequate capabilities, investing in both human resources and systems, to be in a position to assess this risk independently.

In this context, the Eurosystem notes that the following aspects should be considered by the Commission when making proposals concerning the possibility for financial firms to establish an independent internal framework for sovereign credit risk assessment.

First, the assignment of a sovereign rating is a lengthy process and a synthesis of quantitative measures and qualitative judgements that

3 "*Banks, market participants and institutional investors should be expected to make their own assessments and not rely solely or mechanistically on CRA ratings*", in *Principles for Reducing Reliance on CRA ratings*, Financial Stability Board, 27 October 2010.

capture both capacity and willingness to repay debt.[4] As such, it should incorporate a wider range of factors[5] than only the financial strength of the sovereign, including macroeconomic analysis.[6] In addition, CRAs typically rely on numerous interactions with key sovereign authorities, which financial firms may not have access to, especially those of medium or small size or with limited international scope.

Second, although CRAs' published methodologies are quite generic in their description (see also Section 2), rating agencies carry out factors analysis and they compare each sovereign against a similar pool of peers.[7] As part of the process, all large CRAs make use of proprietary models generating scores calibrated to the default ratings. Forward-looking evaluations of the risk of default over a medium- to long-term time horizon are then performed, and the examination of past experience is supplemented by medium-term projections and the construction of a range of scenarios that stress-test the vulnerability of a country's economic, political and financial situation to a variety of shocks generated both internally and externally. The extent to which financial firms of all sizes and financial sophistication can replicate or substitute these components of the sovereign analysis is not clear, especially if their geographical differentiation is limited.

Finally, any proposal for implementation for financial firms should include the request to develop clear procedures and mechanisms in the credit management framework to describe and regulate how firms design and update methodological aspects of sovereign assessment.

In general, internal risk assessments may not be as broad as the rating analysis from the CRAs and one should also keep in mind that some investors and institutions may not have the economies of scale to do their own credit assessments. It is usually noted that internal credit analysis by financial institutions tends to have a more partial approach with focus on large and/or domestic issuers. This could adversely affect the demand for smaller issuances. However, it is acknowledged how complex it is for policymakers to regulate the use of credit ratings by investors when it comes to internal policies and in contracts.

1.2 USE OF EXTERNAL RATINGS IN THE MANDATES AND INVESTMENT POLICIES OF INVESTMENT MANAGERS

Regarding the use of external ratings in investment mandates and policies, the Eurosystem suggests that for those markets and funds where it is assessed that decisions triggered by these mandates have significant economic value for the firm and a potentially significant impact on markets, introducing a flexibility clause in the investment mandates might reduce the simultaneous and forced selling of distressed securities. The advantages of introducing a flexibility clause in investment mandates are associated with a) the relative ease and speed to implement this measure and b) the contribution to mitigating cliff effects of ratings downgrades.

From a risk management perspective, the institution should not introduce flexibility at

4 In addition to quantitative and qualitative analysis, the process involves stress tests results and forward-looking economic and financial projections, which although based on public information, may vary considerably in their outcome.

5 For example, key economic and financial data are regularly drawn by CRAs from a number of international sources, including the IMF, OECD, Eurostat, the World Bank and the BIS. Data and statistics are maintained in a database which is used to generate economic forecasts and conduct peer comparisons on several sovereign credit metrics across the rating scale. Additionally, analysts monitor political, fiscal and monetary goals and decisions, through information provided by treasuries, central banks and outside observers. Market based indicators and the dynamics of financial markets are also deemed relevant.

6 CRAs focus specifically on "sovereign *default* risk", i.e. the likelihood of a government defaulting in its own obligation, which varies with the different definitions by different CRAs, with the assumptions made and with the calibration of parameters. These components and the weights assigned in the calibration are not described, and at times not even acknowledged, in the CRAs' methodology documentation.

7 For example, an agency typically assesses for each category and sub-category whether its factors are considered a strength, weakness or neutral factor for the sovereign, relative to its rating peer category and whether trends in each are positive, stable or negative.

the expense of adequate risk protection. Therefore, the institution should avoid departing from the 'benchmark' or the level of risk tolerance approved in the investment guidelines without explicit approval. The use of flexibility clauses should therefore be a conscious decision of the board. In an environment in which creditworthiness of counterparts is under stress, the institution would be taking on more risks than without the clause in place. The introduction of a flexibility clause should be optional for financial institutions. All aspects related to the functioning of the clause should be carefully assessed and documented.

1.3 APPLICATION OF STANDARDISED APPROACHES

The Eurosystem suggests making the distinction between financial institutions' internal assessment and due diligence on the one hand and methods to calculate the required capital requirements on the other hand. Internal risk assessment and due diligence are separate management functions to capital management which may consist of translating (distributional) risk estimates into capital requirements. Making clear this distinction allows for the use of standardised approaches to calculate required capital by smaller/less sophisticated firms, while still requiring that these firms develop adequate risk assessment and due diligence capabilities commensurate with their activities.

In this respect, the Basel II framework contains adequate incentives for financial firms to gradually adopt the internal models approach, as their credit risk management expertise improves, through potentially lower required capital vis-à-vis the standardised approach. The framework offers an appropriate approach to banks to move away from the standardised approach without recourse to strict limits. Strict limits could force firms to adopt an internal models approach, without the firms having the necessary expertise. Therefore, any use of internal methods to calculate regulatory capital should remain subject to careful supervisory approval, and thus only be allowed when proven to be adequate.

Finally, the consultation paper's proposal to require the use of two external ratings for regulatory capital calculations might be difficult to implement without a larger offer of external ratings than today. The proposed requirement to rely on the worst rating of two external ratings could as well reduce the practice still observed in securitisation markets of ratings shopping. However, to effectively address ratings shopping other initiatives addressing the functioning of the credit rating market would be needed as proposed by the consultation paper.

2 SOVEREIGN DEBT RATINGS (QUESTIONS 16-22)

2.1 ENHANCE TRANSPARENCY AND MONITORING OF SOVEREIGN DEBT RATINGS

The Eurosystem fully supports initiatives and recommendations that enhance transparency and disclosure of the methodology and rating process in relation to sovereign debt. In addition, the harmonisation of key definitions (such as for sovereign default) would be welcome as it would add clarity on the meaning of ratings by different CRAs. The proposals of the Commission contribute towards clarifying the process of rating sovereign debt, although key details of their implementation are to be further specified.[8] The Eurosystem agrees that sovereign ratings issued in a timely manner and accurately reflecting all the available information would in turn contribute to reducing the volatility of ratings themselves, even out the effect that announcements would have on market variables, and improve their validity both in regulatory frameworks and in comparison to internal assessments. However some substantial issues related to the CRAs'

8 E.g. it is not clear how feasible it is to oblige CRAs to publish their internal research reports on sovereigns.

methodology for sovereign ratings would need further clarification.

First, it is not clear how the major facilities established to address recent crises – namely, the European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF) – and, in general, interventions by public institutions and Governmental budget austerity plans are evaluated by the ratings of the countries concerned.

In addition, the so-called 'country ceilings', through which some CRAs limit the maximum rating of some financial instruments (esp. structured finance) in consideration of the sovereign rating, cap the rating of assets *a priori*, so that no amount of extra stresses in the rating analysis of credit protection is deemed sufficient to achieve ratings higher than the cap.[9] In general, the application of rating caps for structured finance transactions is doubtful from an analytical perspective, since according to the engineering of securitisation it should always be possible for a senior tranche to achieve an AAA-rating, provided that the level of credit enhancement is big enough. From what can be assessed of CRAs methodologies at present, it is difficult to determine in advance the highest achievable rating of a structured finance transaction in a specific country. Therefore, mechanical rules should be subject to screening and should be clearly documented by CRAs and indicated in the rating announcements, how important country risk considerations weigh in the credit assessment for structured finance transactions should be made more transparent.

Second, as regards monitoring, sovereign ratings could be reviewed more frequently and regularly at times of crisis. If, for example, CRAs issue regular reports (e.g. weekly) on their monitoring of sovereign under stress, in a sort of renewed meaning of "watch negative", the information shock of a downgrade could be better priced by markets, and multi-notch downgrades would not be necessary.

Third, as regards the Commission's proposal that CRAs should inform a country's authorities ahead of the publication of a sovereign rating, as a general principle this should occur, both for solicited and unsolicited ratings or reviews. In addition, CRAs should explicitly indicate if a sovereign (or supra-national) rating is unsolicited, and the communication of the rating issuance should indicate in detail how the rating methodology has departed from the one used for solicited ratings.[10]

In general, it cannot be avoided that announcements of rating actions or even of changes of outlooks have consequences on a country or geographical area and its financial stability. In fact, the IMF report quoted in the consultation paper states that "sovereign ratings do in fact influence markets, although more via credit warnings ("outlooks," "reviews," and "watches") than through actual rating changes". Therefore, as long as transparency is required and granted on how the methodology is specified and used (especially as regards objective, quantifiable variables versus subjective or qualitative features), the market will use the information available and price it in the valuation of assets.

2.2 ENHANCED REQUIREMENTS ON THE METHODOLOGY AND THE PROCESS OF RATING SOVEREIGN DEBT

The Eurosystem fully supports measures aimed at increasing the disclosure, transparency and clarity of methodologies, models and assumptions parameters surrounding the approach adopted by each CRA. Quantitative measures are only one part of the input into sovereign rating decisions.

9 The main argumentation for such approach is that the macroeconomic instability that is generally associated with a sovereign default may result in a sudden deterioration in the creditworthiness of a securitised pool of loans.

10 Presumably, in the case of an unsolicited rating, the CRA could not benefit from the usual documentation provided, especially in connection with new bond issuances (e.g. official statements, financial statements, the latest budget information, economic assumptions and trends, relevant legal documentation, etc.), nor from meetings with the sovereign authorities.

They provide useful information on the historical performance of the economy and on its fundamental structural features and can reveal significant trends and cyclical patterns. However, they constitute only the basis for the analysis. While providing extensive information on the main analytical considerations, CRAs fail to publicly disclose details on the precise functions and econometric models employed.[11]

Given the relatively small number of sovereign defaults, the methodology used by CRAs may not offer a reliable and consistent measure of the sovereign specific creditworthiness. Similarly, to provide an indication of their performance, CRAs measure their performance in terms of Cumulative Accuracy Profile and Accuracy Ratio, quoting academic studies which indicate that the historical average one-year accuracy ratio for the sovereign ratings is around 94%, and that the 23% of the lowest-rated sovereign issuers have accounted for 100% of the defaults. However, given the relatively small number of sovereign defaults, these methods may not offer a reliable measure of the ratings performance. Moreover, no disclosure is provided by agencies on the econometric models employed in the valuation, or on the forecasting and stress-testing exercises employed in the process.

Finally, as indicated in Section 1, it has been observed that there is no harmonised definition of sovereign default among CRAs, which is reflected also in the calculation of corresponding probabilities of default. CRAs encompass a broad range of situation (and exceptions) into the definition of default and the distinction is often discretionary. A better standardisation of definitions would help investors' understanding of ratings themselves and of actions, especially in times of crisis.

3 ENHANCING COMPETITION IN THE CREDIT RATING INDUSTRY (QUESTIONS 23-37)

Regarding competition in the credit rating agencies sector, one of the possible flaws commonly highlighted concern the oligopolistic structure of the global credit rating market dominated by very few CRAs.[12] In this context, the Eurosystem supports the importance of addressing this issue and welcomes the Commission's initiative of launching a wide policy discussion with this consultation.

In general, there are different ways to address the problem of functioning of the credit rating market: one would be to enhance competition by facilitating market entry, with several possibilities pointed out by the Commission and discussed below. The US[13] has opted to increase competition in the credit rating market, mainly by increasing transparency of credit ratings as regards data used, methodology, and assumptions made in the models. The requirement to consider independent data when available and the publishing of a track record of ratings should also help to spur CRAs competitiveness.

In this context requiring firms to use at least two external ratings issued by different credit

11 Fitch indicates to have a proprietary sovereign rating model to ensure consistency of ratings across regions and time, although the actual rating eventually determined by the sovereign rating committee can and does differ from that implied by the rating model. Standard & Poor's ranks each sovereign on a scale comprising six rating grades for each of the analytical categories. Budgetary performance is a central component of their financial analysis. Special attention is paid to revenue forecasting, expenditure control, long-term capital planning, debt management, and contingency plans. The debt burden relative to the economic and population base, as well as the government's debt structure and funding sources are considered. Moody's approach starts from the above listed categories and follows a three step process: the economic strength and the institutional strength of the country are combined to determine its shock-absorption capacity. The government's financial robustness is then assessed, through the combination of the financial strength and the susceptibility-to-event risk. To each of the four broad category, a 1 to 5 score (from "very high" to "very low") is attributed and then mapped into a "rating road map" which broadly identifies the applicable rating range. This is done by adjusting the degree of resiliency to the degree of financial robustness. The determination of the exact rating is finalised on the basis of a peer comparison, and weighting additional factors that may not have been adequately captured earlier and is achieved in the Rating Committee.

12 According to the US Securities and Exchange Commission, in the US three CRAs (Fitch, Moody's and S&P) issued in 2009 97% of all outstanding ratings across all categories reported (SEC, Annual Report on Nationally Recognised Statistical Rating Organisations, September 2009).

13 See Annex 4.

agencies and to consider the exposure as unrated unless at least two external ratings exist would be easier to implement with a larger offer of external ratings than today and with an environment that fostered the development of new players on the market.

3.1 ENHANCING TRANSPARENCY

To alleviate the current market distorting oligopolistic situation, the first step would be to address barriers that could hinder competition. One particular way of addressing such barriers could be to eliminate obstacles that prevent potential competitors from obtaining information needed to assign ratings. In this context, the Eurosystem would support provisions requiring the hired CRAs to make accessible the data they receive to non-hired CRAs when rating structured finance products and other instruments such as corporate bonds, with the aim to further reduce barriers to entry by allowing smaller CRAs to build their reputation and increase their chances to secure business. Moreover, not only could these measures further reduce barriers to entry for smaller CRAs, but also could potentially encourage enhanced internal risk management by investing institutions. These measures would also contribute towards ratings transparency, since several ratings for one product, based on the same information, would be visible to the competing CRAs and some would be made public to all market participants. To ensure data confidentiality but maintain data disclosure for a wide range of market participants, the information access should be extended to all registered CRAs.

The establishment of loan-level data requirements for ABSs in the Eurosystem collateral framework, announced on 16 December 2010, provides an example of transparency arrangements and access to information specifically from a central bank's perspective.[14] The Eurosystem may require loan-by-loan information for securitised transactions in its collateral framework, with the aim of increasing transparency in the ABS market. This information will significantly improve the capacity to produce due diligence checks for risk assessment and valuation purposes. These transparency requirements may also encourage the entrance of new players given the concrete incentives by the Eurosystem regarding disclosure standards.[15]

3.2 THE CENTRAL BANKING FRAMEWORK

The Commission's paper enquires whether it would be useful for the ECB to provide ratings for regulatory purposes. The ECB should not issue public ratings to be used for regulatory purposes.

Notwithstanding, the Eurosystem fully supports the efforts to reduce the reliance of financial markets and the official sector on CRAs' ratings and to diminish the impact of "cliff effects" of the regulatory use on financial institutions and markets.

In this context, the ECB itself started a process to enhance and develop further its internal capabilities for independently assessing the creditworthiness of issuers and issues eligible for credit operations and for critically reviewing external assessments. As a credit risk taker, all asset classes eligible as collateral for monetary policy operations should be covered. The main problems identified in the past about reliance on external credit assessments are, on the one hand, the validity itself of the assessment (a risk management consideration), and on the other hand the abrupt effect of rating changes and their timing, which may cause sudden shortages of eligible collateral that trigger financial stability considerations and pro-cyclical effects.

14 See the ECB internet website http://www.ecb.europa.eu/press/pr/date/2010/html/pr101216.en.html and the dedicated web page http://www.ecb.europa.eu/paym/coll/loanlevel/html/index.en.html. A summary of the announcement is available in Annex 2.

15 The high start-up costs for new players to enter credit rating agency sector, especially regarding structured finance instruments, are in part derived from access to accurate information. Such barriers to entry can be diminished by easier access to a standardised format and timely data on single loan exposures.

Every year, the ECB reviews the functioning of the Eurosystem credit assessment framework (ECAF), namely the procedures, rules and techniques in order to ensure high credit standards for all eligible assets. Thus far, the ECAF allowed the recognition internally to the Eurosystem of the four in-house credit rating assessments from the respective EU National Central Banks[16] and the performance is positive despite the current financial crisis. These in-house credit rating assessments have been regular functions of the respective EU National Central Banks for years, allowing those institutions to build up experience, solid internal procedures and quality controls, qualified human resources, strong data warehouses based on credit registers, and a constant improvement of their credit rating methodologies. On the other hand, the conduct of rating activity as in-house credit rating assessments always raised questions regarding reputation risks and potential conflicts of interest, beside other risks, that need to be properly addressed by the Eurosystem at all time.

The in-house credit rating sources seem to facilitate the existence of credit ratings for smaller and medium companies in the corporate sector, a part of the market not totally covered by the external credit assessment institutions.[17]

In summary, the Eurosystem framework is sufficiently flexible to accommodate and support the aforementioned evolution of the credit rating business and possible further development of new in-house credit rating sources within ECAF. The Eurosystem notes that in-house credit rating sources are recognised internally. As regards ECAF, the Eurosystem is prepared to continuously review the procedures, rules, methods, systems and resources used by in-house credit rating sources, taking into account the objectives to reduce the over-reliance on external credit ratings and improving internal credit risk assessment capabilities.

3.3 PUBLIC/PRIVATE STRUCTURES

The Commission's paper mentions among the possible options the establishment of a new independent European Credit Rating Agency, with the cost wholly or partially covered by the private sector. However, the degree of independence of such an agency funded wholly or partially by public money remains to be assessed. Furthermore, such an Agency would have to be equipped with extensive data, models and experienced staff. In this context, it is unclear how long it would take until the Agency could credibly issue ratings with a stable and solid methodology and in compliance with the features required by the CRA Regulation, i.e. to be rigorous, sound, continuous and subject to validation based on historical experience. In particular, the requirement of validation and the practical issue of building a track record over several years could make the Agency not operative for some time. Finally, it remains to be ascertained whether the creation of a semi-public agency would result in increasing competition, or rather create artificial barriers to entry for new private entities and therefore ultimately reduce competition.

3.4 NETWORK OF SMALL AND MEDIUM-SIZED CREDIT RATING AGENCIES

The Eurosystem notes that the idea of a European network of small and medium-sized CRAs merits to be further developed. A network of small and medium-sized credit rating agencies will help build up expert knowledge and improve methodologies, capable human resources, data exchanges, development of common IT systems, internal controls, and extra capacity that may improve the quality of the ratings. Ideally, a network could provide some support in the early stages of a CRA business being set up and increase visibility of ratings of its members while each smaller CRA may specialise in a specific rating activity. This would also help the reputation-building

16 Banque de France, Deutsche Bundesbank, Banco de España and Oesterreichische Nationalbank.

17 An increasing number of companies is assessed by the ECAF-recognised in-house credit rating sources, and those credit risk assessment sources seem to co-exist with other competitive sources of ratings. See Annex 3 for a list of ECAIs approved by ECAF and supervisory authorities.

of small or new CRAs, which is essential in an information-driven service sector. The existence of networks facilitates the ECB's reviews of the procedures, rules and techniques used in external credit rating services and rating tools under ECAF.

The new CRA regulation also needs to avoid the potential exit of some small and medium-sized CRAs from the ratings sector. A more comprehensive study could be developed to take such potential barriers for small and medium-sized CRAs into account.

4 CIVIL LIABILITY OF CREDIT RATING AGENCIES (QUESTIONS 31-33)

The Eurosystem notes that a high standard of civil liability for CRAs has been introduced in the US law. The applicability of a similarly high standard should be further studied for the EU single market, taking into account the US experience, particularly regarding making CRAs liable for the performance of ratings when they have failed to conduct a reasonable investigation into the facts used by its methodology or verify them if obtained from other parties. Additionally, any framework that includes civil liability should not give misleading signals to investors as regards their handing over responsibility for their decisions to rating agencies, both 'morally' and legally. This would be counterproductive as regards the intended enhancement of internal risk management. Moreover, it could distort the information value of ratings (e.g. lead to overly pessimistic ratings) or further reduce the number of available external ratings.

5 POTENTIAL CONFLICTS OF INTEREST DUE TO THE "ISSUER-PAYS" MODEL (QUESTIONS 34-37)

To perform their role in the financial markets adequately, in general CRAs must avoid conflicts of interest and manage and disclose them where they arise. The Eurosystem agrees that the current "issuer-pays" financing model of ratings can be a source of conflict of interest and thus may have a distorting influence on ratings. However, not just the type of payment model can lead to conflicts of interest, the lack of transparency regarding payment models and modalities can also lead to less than ideal outcomes. Regarding the options proposed in the consultation paper, the Eurosystem would have the following preliminary comments.

First, the consultation paper mentions a "*Subscriber/Investor pays model*": institutional investors could be required to obtain their own rating before they can purchase a particular financial instrument. This may be supported as it would help creating a "subscriber-pays" rating market. First, some evidence from the US shows that newly founded rating agencies are more likely to use the "subscriber-pays" rather than the "issuer-pays" model, whereas the bigger CRAs use "issuer-pays".[18] However, it is unclear if this is due to timing or perhaps related to the smaller size and higher specialisation of the smaller firms.

The Commission's proposal may support the emergence of a new model, however it should be borne in mind that other models also involve conflicts of interest and bring about distortions in the market, albeit of a different nature.

For example, if one of the ratings is published, the incentive for paying for another rating is greatly reduced, as a free-rider problem would arise. Also, institutional investors may prefer to conduct their own due diligence. Therefore, the additional costs of such an option for the investors should be carefully evaluated. Moreover, such an option would need to be based on regulatory intervention (such as those discussed in Section 3) ensuring that the CRAs hired by the investor would actually have access to the same information as those hired by the issuer. The limited publication of such

18 US Security and Exchange Commission (September 2009), "Annual Report on Nationally Recognized Statistical Rating Organisations", p. 18.

non-issuer-hired ratings (the recast envisions 10%) should further increase transparency while keeping free-riding to a minimum.[19]

Second, the consultation paper mentions a "Government as hiring agent" model: such option resembles the solution under development in the US[20] where the supervisory authority would be entrusted with choosing the initial rating agencies for structured finance products. The exact details are not yet clear, and the law also entrusts the US Securities and Exchange Commission with conducting a study on the appropriate methods of paying fees to CRAs as well as possible alternative means for compensating them. If the study were to be conducted in Europe, ESMA could be charged with such responsibility. In any case, the EU should carefully assess the introduction of a non-market payment model, as it may have unexpected consequences.

Finally, another option to increase competition would be an "initial review" fee. This idea (supported by the Eurosystem in the September 2008 reply to an earlier Commission's public consultation on CRAs) was hatched in an agreement between CRAsv and the New York State[21] on the rating of RMBS. It would entail the CRA charging a fee for the review of a product, regardless of whether it is later selected for issuing rating in the end. This could also serve to reduce ratings shopping by issuers.

19 Also see ECB Opinion CON/2010/82 of 19 November 2010 for a discussion of the proposed Articles 8a and 8b, which detail this mechanism.
20 Dodd Frank Act Sec. 939F.
21 See http://www.ag.ny.gov/media_center/2008/jun/june5a_08.html (agreement of New York and the big three rating agencies).

ANNEXES

1 QUESTIONS IN THE COMMISSION'S CONSULTATION PAPER

QUESTIONS 1 - 15: OVERRELIANCE ON EXTERNAL CREDIT RATINGS

1) Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?

2) How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?

3) Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?

4) What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?

5) Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed? To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?

6) Can the existing "supervisory formula" based approach in the Capital Requirements Directive be considered to be sufficiently risk sensitive to become the standard for all securitisation capital requirements? If not, how could its risk sensitivity be improved without placing reliance on institutions' internal estimates other than default probability and loss for the underlying exposures? In the insurance sector, how do you assess the approach to credit risk for structured exposures used in QIS 5?

7) Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?

8) What information should be disclosed to supervisors in order to enable them to monitor the internal risk management processes of firms with particular focus on the use of external credit ratings in these processes?

9) To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in their investment policies, risk management processes and in investment mandates?

10) What further measures, in addition to the disclosure proposals included in Articles 8a and 8b41 of the proposal amending the current CRA Regulation could be envisaged?

11) Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?

12) Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?

13) Should investment managers be obliged to introduce measures to ensure that the

proportion of portfolios that is solely reliant on external credit ratings is limited? If yes, what limitations could be considered appropriate? Should such limitation be phased in over time?

14) What alternative measures of credit risk could be used to define the minimum standard of credit quality for a portfolio? Are rolling averages of bond prices/CDS spreads a suitable risk measure for this purpose?

15) What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates?

QUESTIONS 16 - 22: SOVEREIGN DEBT RATINGS

16) What is your opinion regarding the ideas outlined above? How can the transparency and monitoring of sovereign debt ratings be improved?

17) Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?

18) Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?

19) What is your opinion on the need to introduce one or more the proposed measures?

20) More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?

21) Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?

22) What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

QUESTIONS 23 - 30: ENHANCING COMPETITION IN THE CREDIT RATING INDUSTRY

23) How could new players be encouraged to enter the credit rating agency sector?

24) Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions? If yes, which asset classes (corporate, sovereign, structured finance instruments etc) could be considered?

25) Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?

26) Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level? How could such agencies be structured and funded and what entities and products should they rate? What are the potential advantages and disadvantages of this approach?

27) Is there a need to create a new independent European Credit Rating Agency? If so, how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit

rating agency? What are the potential advantages and disadvantages of this approach?

28) Is further intervention needed to lower barriers to entry or expansion in the credit rating agency sector in general or as regards specific segments of the credit ratings business? What actions could be envisaged at EU and at Member State level?

29) Would the creation of a European Network of Small and Medium Sized Credit Rating Agencies help increase competition in the credit rating agency sector? What are the potential advantages and disadvantages of this approach?

30) Do you consider that there are any further measures that could be adopted to enhance competition in the rating business?

QUESTIONS 31 - 33: CIVIL LIABILITY

31) Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?

32) If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?

33) Should such a potential liability regime cover solicited as well as unsolicited ratings?

QUESTIONS 34 - 37: POTENTIAL CONFLICTS OF INTEREST DUE TO THE "ISSUER-PAYS" MODEL

34) Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?

35) What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the "issuer-pays" model? If so, please indicate which alternatives appear to be the most feasible ones and why.

36) Are there any other alternatives to be considered? If so please explain.

37) Are there any other issues that you consider should be tackled in the forthcoming review of the CRA Regulation?

2 THE ABS LOAN-LEVEL INITIATIVE

INTRODUCTION

The ABS loan-level initiative establishes specific loan-by-loan information requirements for asset-backed securities (ABSs) accepted as collateral in Eurosystem credit operations. It will increase transparency and make available more timely information on the underlying loans and their performance to market participants in a standardised format. In the past, assessments of asset-backed securities have been hampered by the lack of standardised, timely and accurate information on single loan exposures. The Eurosystem believes that the new data requirements will help both investors and third-party assessment providers with their due diligence. Ultimately, more transparency will help to restore confidence in the securitisation market.

The Eurosystem investigated the usefulness of ABS loan-by-loan information for market participants via a public consultation and received overwhelming support for the initiative.

THE MAIN OBJECTIVES

The loan-level initiative aims to:

1. improve transparency in ABS markets by requiring loan-by-loan information to be available and accessible to market participants on an ongoing basis. This is considered necessary to revive the ABS markets;

2. facilitate the risk assessment of ABSs as collateral used by Eurosystem counterparties in monetary policy operations.

THE INTRODUCTION OF ABS LOAN-LEVEL DATA REQUIREMENTS

The Eurosystem will take into account loan-level data to determine whether ABSs are eligible as collateral in its credit operations. Via its collateral framework, the Eurosystem can help to improve market functioning and the transparency of the securitisation structures.

The Eurosystem intends to introduce the loan-by loan information requirements for residential mortgage-backed securities (RMBSs) first and then gradually to other asset classes, such as commercial mortgage-backed securities (CMBSs) and small and medium-sized enterprise (SME) transactions. The requirements will apply to existing and newly issued ABSs and are expected to be introduced in the 18 months following the announcement on 16 December 2010.

3 ECAI'S APPROVED BY ECAF AND SUPERVISORY AUTHORITIES

Table below lists the approved ECAIs by Euro area national supervisor (data as of July 2010). It is to be noted that the number of approved ECAIs by supervisors exceed that of the Eurosystem. In addition to the already four main ECAIs (S&P, Moody's, Fitch and DBRS) and Lince and ICAP that are accepted by the Eurosystem as rating tools, various national 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.

In 2009, ECAIs eligible within the ECAF concentrated their efforts in refining their rating methodologies in similar areas. None of the ECAIs undertook major efforts to refine the methodology regarding the credit assessment of financial institutions, despite the fact that the ratings showed an unsatisfactory performance in the investment grade area for a second year in a row. Most of the rating agencies updated their covered bond rating methodologies in particular as regards liquidity risk. In the area of structured finance, efforts were concentrated on the refinement of counterparty risk criteria and of updates in the rating model assumptions.

List of ECAI's approved by Supervisory Authorities by country

	Moody's	S&P	Fitch	DBRS	Japan Credit Rating (JCR)	Banque de France	Coface	ICAP 1)	Lince 2)	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: NCBs' contributions as of 13 July 2010.
1) Lince is recognised as an ECAI for Capital Requirements purposes by Banca d'Italia and is recognised as a Rating Tool for ECAF purposes.
2) ICAP is recognised as an ECAI for Capital Requirements purposes by Bank of Greece and is recognised as a Rating Tool for ECAF purposes.

4 REGULATORY CHANGES IN THE US DUE TO THE DODD-FRANK ACT

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), which will have to make more than 10 new rules relating to NRSROs. First staff proposals are expected in early 2011, as the deadline is in July 2011. NRSROs were also involved in the rulemaking via letters of consultations that were sent out shortly after Dodd was signed in to law.

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. Important elements of Dodd relating to the European Commission's consultation are:

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 "meet standards of credit worthiness" as defined by the appropriate regulator.

2 SOVEREIGN DEBT RATINGS / 3 ENHANCING COMPETITION

Requirements to take into account independent information from sources other than the rated entity.

Requirements to disclose rating methodology, assumptions underlying the rating, data used for the rating and a track records of ratings

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.

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.

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