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COMMISSION STAFF WORKING DOCUMENT
SUMMARY OF THE IMPACT ASSESSMENT

Accompanying document to the

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

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

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1. PROBLEM DEFINITION

An essential element of the CRA Regulation is the introduction of an external oversight regime whereby European regulators will supervise the issuance of credit ratings by CRAs¹. The CRA Regulation has introduced a system of supervision based on colleges of competent authorities of the Member States, which gives the possibility to all concerned competent authorities to participate in the process of registration and supervision of a credit rating agency or a group of CRAs; although the final decision is always taken by the competent authority of the home Member State. The supervisory framework of CRAs was one of the most difficult subjects in the negotiations between the Council and the Parliament, successfully concluded on 23rd April 2009. The De Larosière report of March 2009 followed by the Commission Communication of 27th May 2009 opened at political level the possibility to create a Community Agency which would deal with issues beyond CRAs. The compromise solution on the CRA Regulation envisaged already the need to review the supervisory provisions of the Regulation taking into account the new developments at political level. The Commission proposal for a new supervisory structure in Europe establishing three European Supervisory Authorities has changed the picture. The Council agreed in December 2009 to entrust in principle the new ESMA with direct supervisory powers on CRAs².

However, it is not merely political sentiment that goes in favour of considering more centralised EU oversight of CRAs. There are strong factual indications that such an approach would better correspond to the business specificities of this sector:

- (i) mobility of the rating service, which may be easily provided from varying locations (e.g. a German analyst operating in a London office of a French CRA producing a rating on an Italian company);
- (ii) cross-border impact of ratings on users located beyond the geographical limits of a jurisdiction (e.g. ratings issued by a Japanese CRA may be used for calculating risk capital by banks in various Member States).

The activity of CRAs is markedly different from the one of banks or insurance companies. It does not have such a strong territorial attachment (in terms of physical presence or capital engagement) and the impacts over a particular jurisdiction of events concerning a particular CRA can be much less discernible.

Consequently, and though the supervisory framework currently prescribed by the CRA Regulation has not been put in place yet, it is already possible to identify certain shortcomings. Those deficiencies and their main consequences for CRAs and supervisors are:

¹ The CRA Regulation replaced a previous policy approach in this respect, under which the CRAs were expected to incorporate all the provisions of the IOSCO Code into their codes of conduct. However, that self-regulatory approach did not deliver on expectations as it had been followed on a voluntary basis by CRAs, which were often taking advantage of the "comply or explain" principle. Under that approach an in-depth, independent examination of the actual compliance was not possible. The start of the financial crisis shed light on significant weaknesses of the CRAs in their internal organisation, transparency and managing conflicts and thus prompted a new, more exacting EU policy in this matter.

² See Article 6(3) of the Presidency compromise on the ESMA Regulation (general approach) agreed by ECOFIN on 2 December 2009 <http://register.consilium.europa.eu/pdf/en/09/st16/st16751-re01.en09.pdf>

1.1. Multiplicity of supervisors involved and risks of conflicts over competences

The complex supervisory framework, involving (i) mandatory close co-operation between competent authorities and (ii) actual use of supervisory and enforcement powers by only some of them, has been structured in that way to ensure that interests of all relevant supervisors were well represented and taken into account by those taking the final decision. At the same time it had to take into account the specific nature of the rating activity. Consequently, the division lines between geographical competences of supervisors were not set too firmly, creating room for potential intra-EU disputes. Importantly, this policy choice implies that the CRAs would be faced with the duty to interact with several competent authorities in the same field. The main problem arising from this situation is the risk of conflicts over competences, which may lead to potential gaps (ineffective supervision); overlaps (inefficient supervision); or arbitrage/unlevel playing field.

1.2. Risk of divergent and inconsistent application of the CRA Regulation in individual acts by competent authorities in the Member States

Irrespective of several elements triggering close co-operation between individual supervisors (e.g. work in colleges), the existing model for CRA supervision is ultimately based on the exercise of supervisory and enforcement powers by individual regulators in the Member States. It is possible for the competent authority of the home Member State to override the views of its partners participating in the college. It is also possible for a competent authority of the host Member State to take an individual action, not approved by the relevant college. This can lead to divergent and inconsistent application of the CRA Regulation in individual acts by competent authorities in the Member States.

1.3. Burdensome and time-consuming administrative process

Dealing with several supervisory authorities across the EU would involve substantially higher compliance costs for the rating agencies. On the supervisors' side, the demanding co-ordination and consultation rules, which are a corollary of having all interested authorities engaged in the supervisory and enforcement process, are expected to weigh heavily on the ability of the EU supervisory framework to produce timely and efficient outcomes³.

1.4. Risk of misaligned incentives: can national supervisors cope with the pan European dimension of CRAs?

Competent authorities in the Member States may perceive the dimension of CRA supervision mainly from a national perspective missing a full picture of the global nature and impact of a CRA's activity. Especially in situations where the main impact of a CRA lies outside the Member State where it is registered, there is the risk that the home competent authority does not allocate sufficient resources for the supervision of this CRA. It could create conflicts that the competent home supervisor, which is used to being responsible for its home financial market and accountable to its national political institutions, has to take the main responsibility for CRA activities with pan- European reach affecting primarily financial markets outside its

³ For example, in order to take a supervisory measure (like suspending the use of a rating), the competent authority of the home Member State may be expected to notify the college and the college facilitator, then consult the college on a proposed measure, and if no agreement can be reached consult the CESR, and the college again. Only after those iterations are completed, the competent authority may take a decision.

home jurisdiction. This inherent conflict may necessitate time consuming and costly coordination/enforcement actions by ESMA and the Commission.

2. SUBSIDIARITY AND PROPORTIONALITY

The problems identified in section 1 cannot be effectively addressed at Member States level as they stem from existing EU legislation and can only be addressed through changes in EU legislation. The European Commission considers that the solutions proposed respect the principle of subsidiarity and proportionality, given the specificities of the credit rating agency's sector.

3. OBJECTIVES

The amendment of the CRA Regulation aims at: securing effective supervision of CRAs in the EU; streamlining the supervisory architecture for the CRA industry and ensuring legal certainty for CRAs and market participants. At operational level the objectives are the following: (i) ensure a single point of contact and clear competences; (ii) ensure a consistent application; (iii) ensure efficiency gains and (iv) ensure better alignment of incentives for the supervisory authorities to cope with the pan European activity of supervised entities.

4. POLICY OPTIONS

With the intention to meet the objectives set out in the previous section, the Commission services have analysed different policy options:

4.1. Option 1 - Status quo (current CRA Regulation)⁴

This option would consist in maintaining the key elements of the current supervisory set-up, agreed in the course of the negotiation of the CRA Regulation.

4.2. Option 2 - College structure and ESMA

This option reflects the situation that the ESMA Regulation is adopted as proposed by the Commission on 23rd September 2009 and that the supervisory framework as provided by the current CRA Regulation is maintained.

4.3. Option 3 - ESMA to assume direct oversight of groups of CRAs or all EU-based CRAs

Under this option, the CRA Regulation would be revised in order to introduce centralised oversight of credit rating agencies operating in the EU. ESMA would assume general competence in matters relating to the registration and on-going supervision of registered

⁴ We are aware that this option which reflects the supervisory framework under the current CRA Regulation would not be realistic if ESMA enters into force as envisaged by beginning of 2011. In the latter case, ESMA will have additional powers which would also impact on its role regarding the registration and supervision of CRAs. Nonetheless, we think it is important to refer to the current CRA Regulation as baseline scenario as the content of the future ESMA Regulation and in particular how the current CRA Regulation would be adapted to it are not (yet) fully clear. We describe under option 2 a possible scenario how the current CRA Regulation could function under the (future) ESMA framework.

credit rating agencies as well as matters related to ratings issued by rating agencies established in third countries that operate in the EU under the certification or endorsement regimes. Those responsibilities would involve the use of administrative measures and recommendations to the Commission on the use of sanctions on periodic penalty payments.

Within this broad option we may distinguish two alternative scenarios.

4.3.1. Option 3a - CRAs (groups of CRAs) with legal presence in more than one Member State

ESMA's authority would be limited to the supervision of CRAs (groups of CRAs) with legal presence in more than one Member State.

4.3.2. Option 3b - all EU-based CRAs

Under this sub-Option, ESMA would be the sole supervisor of all EU-based CRAs. Moreover, within this framework, if ESMA were to assume exclusive supervisory powers over CRAs, ESMA would be entrusted with an appropriate authority to investigate breaches of the legislation. In order for ESMA to fulfil its new supervisory powers concerning CRAs, it is necessary to provide for sanctioning powers. However, it is necessary to assess whether sanctions are to remain in the remit of the Member States or whether the Commission or ESMA should be entrusted with the sanctioning power. The new framework should aim at ensuring a level playing field and a consistent application of sanctions within the EU.

5. ANALYSING AND COMPARING THE OPTIONS

The different options are assessed against the criteria of single point of contact and clear competences, consistent application, efficiency gains and adequacy of reach of the supervisory authority.

In view of the conclusions reached in the impact assessment, the European Commission considers it appropriate to present a proposal amending the Regulation on CRAs. The proposal should aim at solving the problems identified in the impact assessment:

- by entrusting ESMA with exclusive oversight powers over CRAs. ESMA will be granted powers to request information, to launch investigations, and perform on-site inspections. Where necessary, ESMA might require assistance of national securities regulators in those supervisory activities. The latter may also be delegated specific supervisory tasks (e.g. hearing of a person, carrying out on-site inspections), with ESMA retaining overall responsibility for those activities.
- by entrusting the Commission, acting on ESMA's request, with sanctioning powers within a well defined framework to be developed by means of delegated acts. Sanctions, including fines and periodic penalty payments, will be defined in such a way to provide a proportionate reaction to individual breaches and to create a deterrent effect. The Regulation will include a list of breaches of the provisions of the CRA Regulation that can be enforced by fines when the CRA acted intentionally or negligently.

6. ANALYSIS OF IMPACTS

The impact assessment shows that the preferred options which best addresses the objectives set for this Commission initiative are the direct oversight by ESMA of all EU-registered CRAs and the centralisation of the sanctioning power with the Commission, acting on a recommendation by ESMA.

| Advantages | | Disadvantages | |
|------------|--|---------------|--|
| 1 | Streamlined decision making process – no conflicts over competence | 1 | Need to build oversight capacity from scratch |
| 2 | No risk of incoherent application of EU law across the Member States | 2 | Local CRAs expected to deal with an EU-level supervisor (no intermediate step) |
| 3 | Clear efficiency gains – heavy co-ordination procedures are avoided and resources and expertise are pooled in one organisation | | |
| 4 | Supervisor's perspective, capacity and mandate corresponds to the EU-wide reach of main players | | |
| 5 | Level playing field for the deterrent effect of sanctions and fully consistent application of sanctions throughout the EU | | |

As the current initiative aims to streamline supervision of credit rating agencies, its potential benefits can be deduced from the cost implications of the financial crisis, in which credit rating agencies played a non-negligible role. Even when attributing to credit rating agencies only a fraction of the direct and indirect losses caused by the crisis, the benefits of an effective and efficient supervisory system are vast.

7. MONITORING AND EVALUATION

The Commission is the guardian of the Treaty and therefore will monitor how the Regulation on CRAs is implemented by ESMA. The evaluation of the consequences of the application of the legislative measure could take place three years after the entry into force of the legislative measure in the form of a Commission report to the Council and the European Parliament.