# ICSA

INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS


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European Commission
DG Markt Services
B-1049 Brussels
Belgium

Re: Draft EU Directive/Regulation on the authorisation, operation and supervision of credit rating agencies

The International Council of Securities Associations (ICSA)[1] welcomes the opportunity to comment on the European Commission's consultation paper regarding the authorisation, operation and supervision of credit rating agencies (CRAs). ICSA is composed of trade associations and self-regulatory organizations that represent and/or regulate the securities industry in all major financial markets. As a global organization, ICSA is commenting on the proposed Directive/Regulation because of the potential impact that the new legislation or regulation could have on confidence in the ratings process and the level of competition within the credit rating industry.

We would note from the onset that we strongly support the overarching objective of the proposed Directive, which is to ensure that CRAs provide independent and objective ratings in order to restore market confidence in the rating process. However, we have a number of concerns with the proposed Directive/Regulation, in particular:

- The regional nature of the proposed Directive/Regulation fails to take account of the global character of the credit rating business. Since the larger rating agencies operate on a global basis, any regulatory framework developed for CRAs needs to be consistent with the globally agreed standard in order to achieve the goal of restoring investor confidence. We note that IOSCO is currently exploring how its members can work together to verify effective implementation of the *Code of Conduct Fundamentals for Credit Rating Agencies* (which we consider to be the global standard). We would suggest that decisions on EU regulation of rating agencies should be deferred in order to take account of the outcome of IOSCO's work. We would also suggest that further

[1] For a list of ICSA members and activities, see www.icsa.bz

action at the EU level regarding CRAs should be consistent with the IOSCO framework [in approach, substance and operation] and should be related to the use of ratings in EU legislation.

- The proposed Directive/Regulation is overly prescriptive and could potentially encourage investors to rely even more on the opinions issued by CRAs due to the mistaken belief that the new regulatory framework had eliminated all problems inherent in the ratings process.

- At the same time, the nature of the powers given to Member States in the proposed Directive/Regulation raises concerns about possible political interference in the ratings methodology as well as other decisions of the CRAs, which in turn could undermine market confidence in the ratings process.

- The proposed Directive/Regulation would impose EU regulation on credit rating agencies regardless of where those firms were domiciled, and would therefore have significant extra-territorial consequences. The draft Directive/Regulation may also raise barriers to entry for CRAs, which would reduce rather than increase competition in the industry.

These issues are considered in more detail below:

The larger rating agencies operate on a global basis and it important for the goal of restoring market confidence that any regulatory solutions to the issues identified are developed on a global basis. As the draft Directive notes, IOSCO along with the Financial Stability Forum and the Committee on the Global Financial System have all recently examined problems in the credit rating industry, as has the Committee of European Securities Regulators (CESR) and the European Securities Markets Expert Group (ESME) within the EU. We would note that none of these bodies have recommended regulation for credit rating agencies at a global level, and certainly not at a regional level. Moreover, one important result of this extensive work was the issuance of IOSCO's revised *Code of Conduct for Credit Rating Agencies*, which provides a high-level, principles-based framework for the operation of credit rating agencies. Importantly, the *Code of Conduct* does not seek to dictate business models or governance arrangements at CRAs but instead focuses on ensuring that investors are provided with the information that would allow them to undertake their own appropriate analysis. Currently IOSCO is considering the best methodology for monitoring the effectiveness of the *Code of Conduct* on a global basis. We strongly support the work that IOSCO has done to develop its revised *Code of Conduct* and believe that sufficient time should be given for IOSCO's work plan to come to fruition before rushing into regional regulation.

We would note that, unlike IOSCO's *Code of Conduct for CRAs*, the proposed EU Directive/Regulation appears to be far too prescriptive than is appropriate and may, as a result, have consequences different than those intended by the Commission. An example of the level of inappropriate prescription can be found in Article 7, Paragraph 2, which states that:

> "The home Member State competent authority shall verify that the non-executive members of the administrative board or the members of the supervisory board shall in their majority have sufficient experience in understanding credit risk and relevant modelling sensitivity analysis techniques across the range of investments and credit structures that fall within the scope of activity of the credit rating agency. Their remuneration shall be linked to their experience and skill and to the contribution they make and are contractually expected to make to the supervision, quality, accuracy and integrity of the rating process and activity and not to the growth in earnings or share price of the credit rating agency. Their term of office, which shall be for a preagreed fixed period, shall not be renewable."

We are concerned that this section of the proposed Directive, which we are citing merely as an example, would appear to allow the competent authority of the home Member State to determine: (1) the type of experience that a non-executive director of a CRA must have; (2) whether or not the remuneration of non-executive directors was appropriately linked to their experience, skill and the contribution that they made; and (3) the length of time that an individual non-executive director could be employed by a CRA. However, it is not clear at all on what basis the competent authority would determine the appropriateness of any of the issues identified above. Because it is both overly prescriptive and vague at the same time, we are concerned that the draft Directive/Regulation would set the stage for an unprecedented level of bureaucratic intervention in the day-to-day management of the credit rating agencies.[2]

The nature of the powers given to Member States in the proposed Directive/Regulation also raises concerns about the possibility for political interference in the CRAs ratings methodology and other business decisions. For example, Article 22 of the draft Directive/Regulation would allow the competent authority of the home Member State to intervene in the operations of a CRA registered in its territory in any way that it deemed appropriate in order to protect that Member State's investors or the proper functioning of its markets. This provision along with other sections of the proposed Directive/Regulation raises concerns about the *potential for* political intervention in the ratings process which by itself could undermine market confidence in the independence of the credit ratings issued by the CRAs.[3]

At the same time, we are also concerned that the draft Directive/Regulation could encourage investors to take excessive comfort in the ratings produced by CRAs under the belief that regulators had eliminated all of the problems inherent in the ratings process. As the Commission is clearly aware, not all investors performed appropriate due diligence on the credit instruments that

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[2] We would note, moreover, that this section of the draft Directive/Regulation would undermine the purpose of having non-executive directors, as those individuals are intended to bring a broader perspective to the Board and not participate in the executive functions of the firm.

[3] We would note that Articles 12, cited above, and 21 of the proposed Directive/Regulation also raise concerns about the potential for political interference in the credit rating process.

they were purchasing during the prelude to the current credit crisis. Therefore, we would suggest that it would be important to ensure, to the greatest extent possible, that investors were better able to judge for themselves the risks inherent in any ratings issued by a CRA as the first step in conducting their own independent credit analysis. We believe that the overly prescriptive nature of the draft Directive/Regulation could have the opposite effect and could, in fact, have the same negative impact as full formal regulation.[4] In that case, the impact of the draft Directive/Regulation would be counter to the objective of the Commission's other consultation on the over-reliance on ratings

We are also concerned that the proposed Directive/Regulation would impose EU regulation on credit rating agencies regardless of where those firms were domiciled, and would therefore have significant extra-territorial consequences. Specifically, Article 3, Paragraph 3 of the draft Directive/Regulation proposes that any legal person that issues ratings which are used by investors in the EU would have to establish a subsidiary or branch office in the EU and apply for authorisation. Because no credit rating agency could know with any degree of certainty if their ratings were being used by an investor in the EU, the proposed Directive/Regulation would require virtually all CRAs in the world to set up branch offices and seek authorization regardless of whether or not they were interested in selling their products to EU investors.

In addition, we are also concerned that Article 3, Paragraph 3 of the draft Directive/Regulation could have a negative effect on competition within the global credit ratings industry. Specifically, we are concerned that by forcing all CRAs to set up subsidiary offices in the EU and seek authorization, the draft Directive/Regulation would further raise barriers to entry within the credit rating industry and thereby reduce competition between CRAs. This would go counter to the emphasis of other regulators, such as the SEC, who believe that increased competition within the credit rating industry is necessary in order to improve the overall quality of the ratings process.

In closing, once again we would like to thank the Commission for the opportunity to comment on the draft Directive. Please do not hesitate to contact Jonathan Taylor (jonathan.taylor@liba.org.uk) and Marilyn Skiles (mskiles@sifma.org) to discuss the issues contained in this letter.

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[4] As was noted by the European Securities Markets Experts Group ('ESME') in their June 2008 report to the Commission, "…full formal regulation (of CRAs) may be counterproductive as it might be seen by users in the market place to imply a level of official endorsement of ratings which is neither justified nor feasible." See ESME's Report to the European Commission, *Role of Credit Rating Agencies* (June 2008), *at* Section 3(F), page 22. .