New EU Rules on Credit Rating Agencies: A Brave Step to Better Functioning Financial Markets

By Orestis Omran, Nora Wouters on May 28, 2013

On May 13, the Council of the European Union adopted a legislative package consisting of a directive and a regulation amending the EU's rules on credit rating agencies ("CRAs"). Adoption was preceded by agreement reached with the European Parliament at first reading in November 2012, and subsequent approval by the Permanent Representatives Committee the next month.

The amending legislation aims at reducing investors' over-reliance on external credit ratings, mitigating the risk of conflicts of interest in credit rating activities and increasing transparency and competition in the sector.

The directive will come into force around the beginning of 2015, following its transposition by all Member States 18 months after its publication in the Official Journal of the EU, while the regulation will be directly applicable throughout the EU 20 days after its publication in the Official Journal, namely at some point during this summer. A review report of the new legislation by the European Commission is required to have taken place by July 1, 2016.

The Directive

The Directive amends Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the over-reliance of such strictly regulated financial products on credit ratings. It imposes a general obligation on investment firms to adopt risk management processes to enable the monitoring and measuring at any time of the risk of their positions and the contribution to the overall risk profile of a relevant portfolio while it encourages competent authorities to mitigate the impact of references to credit ratings, with a view to reducing sole and mechanistic reliance on such ratings.

The Regulation

The Regulation imposes a mandatory rotation between CRAs that are employed by issuers of structured finance products with underlying re-securitized assets for their ratings. In particular, such issuers will need to change their CRA every four years. It must be mentioned though that the rotation does not apply to small CRAs, or to issuers employing at least four CRAs, each rating more than 10% of the total number of outstanding rated structured finance instruments.

Public disclosure provisions are introduced in order to mitigate the risks contained in certain conflicts of interests, including the dual shareholdership in both rated entity and rating agency. Shareholders with 5% or more of the capital or voting rights of a rating agency holding 5% or more of a rated entity will have to disclose these interests. Moreover, it is prohibited to own 5% or more of the capital or the voting rights in more than one CRA, unless the agencies concerned belong to the same group.

A provision reducing the current review period of 12 months for sovereign debt ratings to 6 months is introduced with a view to the catastrophic impact those ratings had in the financial credibility of a number of EU Member States in the recent past. In addition, issuers and investors can claim damages for losses incurred following a wrongdoing committed intentionally or with gross negligence by the agency.

Conclusion

Having experienced the serious consequences of uncontrolled CARs in the markets, that contributed substantially to the recent financial crisis, the EU is making a brave step to regulate their influence via the

adopted legislative package. The management of CRAs must be very careful in complying with the new obligations imposed to their agencies while investors and issuers will have to adapt to the new era by designating and applying robust risk management procedures, while avoiding mechanical reliance on ratings produced by CRAs.

Topics: Capital Markets, Credit Ratings, European Commission, European Union, Financing & Lending

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