Rules for Credit Rating Agencies

or Another Unsuccessful Attempt to Establish Uniform and Adequate Standards for Credit Ratings? [1]

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Credit rating agencies ("CRAs") have first been subject to regulatory provisions since 2009 after implementation of the Regulation (EC) 1060/2009 on rating agencies[2]. This regulation, however, merely contained regulatory requirements without providing for a liability of CRAs in connection with the ratings issued by them. This has changed with the recent amendment of the Regulation by a new Regulation (EU) 462/2013[3] which has come into force on June 20, 2013 ("CRA III Regulation" or "the Regulation"). The European legislator appears to have placed great expectations in the Regulation. Michel Barnier, Commissioner for Internal Market and Services who first introduced the European Commission's proposal for a new regulation end of 2011 said that this was *an important step towards restoring financial stability and trust in financial institutions and that it would help to avoid further crises.*[4]

In fact, the new Regulation introduces several amendments to the existing rules while pursuing the former objectives, i.e. to secure the independence of CRAs and their ratings, to restore the trust in the financial markets and to protect the interests of the investors. In order to achieve these objectives, the Regulation most significantly introduces civil liability of CRAs in order to make them more accountable for their actions. As a further focus, the Regulation provides for new rules for the reduction of overreliance of investors and other institutions on credit ratings issued by the agencies. The new rules in addition aim to improve the quality and transparency of the rating process and in particular force CRAs to a greater transparency and continuity with regard to the rating of sovereigns. In addition, several new provisions have the purpose to improve the independence of CRAs and to eliminate conflicts of interests. In particular, the new rules provide for the following amendments:

Amendment No. 1: Reduction of an overreliance on credit ratings

As a first and material amendment, the new rules aim at a **reduction of the reliance** on credit ratings by financial institutions and European authorities and legislation and their dependence from credit ratings. For this purpose, the newly inserted Article 5a of the CRA III Regulation obliges financial institutions, funds and insurance companies to make their own credit risk assessment and not solely or automatically rely on credit ratings. With regard to EU legislation and guidelines and recommendations of EU authorities, Article 5b and 5c of the Regulation establish an obligation of the European supervisory authorities to review and remove, where appropriate, references to credit ratings which have the potential to trigger sole or automatic reliance on credit ratings by December 31, 2013. In addition, these provisions provide for a removal of any reference to credit ratings in Union law by January 1, 2020 if appropriate alternatives to credit risk assessment are available then.

Amendment No. 2: More transparency and continuity with regard to ratings of sovereigns

The Regulation furthermore for the first time adopts certain rules for the rating of sovereigns. In the future, the rating of sovereigns by CRAs will be governed by a newly inserted Article 8a of the Regulation according to which, the ratings of sovereigns must be reviewed – and if necessary adjusted – at least every six months instead of the previous period of every 12 months. The number of unsolicited sovereign ratings is limited to three publications per year under the new rules. Exceptions to this rule are only permitted for the purpose of fulfillment of legal obligations. For the purpose of transparency and continuity, CRAs are obligated to publish a calendar in December every year for the following 12 months showing the dates of the envisaged rating publications. The publication of ratings is only permitted after close of trading and at least one hour before its opening. The establishment of these obligations raises the question whether CRAs in future will be able to adequately react to new developments in the market and to provide up-to-date information which becomes public outside of the calendars they must provide.

As to the content of sovereign ratings, the individual particularities of each state will have to be considered by the CRAs. In addition, in order to establish transparency, sovereign ratings must be accompanied by a detailed research report explaining all assumptions, parameters, limits and uncertainties and any other information taken into account in determining the sovereign's rating.

The new rules also contain general obligations of transparency, according to which CRAs must provide ESMA with new rating methods prior to their implementations and disclose mistakes in existing methods. In general, CRAs must disclose more information about their methods and inform the issuers about the ratings and the reasons for it one day before the envisaged publication. Credit ratings in addition must be submitted to ESMA and will be published on a European rating platform in order to improve the comparability of the ratings issued by different CRAs.

Amendment No. 3: More competition and independence through rotation

In order to improve the independence of CRAs, the Regulation introduces in its Article 6b a mandatory rotation every four years for re-securitizations. With regard to certain complex structured financial instruments, the Regulation establishes a double credit rating, according to which these financial instruments must be rated by two different CRAs. Issuers of these instruments will have to assess the possibility to appoint at least one CRA with not more than 10% of the total market share. ESMA will publish on its website a list of registered CRAs to be considered for that evaluation. However, if an issuer does not act in accordance with this rule, this will merely be registered without further consequences.

Amendment No. 4: Elimination of potential conflicts of interests

One of the main objectives of the Regulation is to eliminate potential conflicts of interest and thereby strengthen the independence of CRAs. As a general rule, the Regulation stipulates the obligation of CRAs to take all necessary steps to ensure that the issuing of credit ratings is not affected by any existing or potential conflict of interests or business relationship involving the CRA or its shareholders, managers and employees. For this purpose, the Regulation establishes limitations as regards the shareholding in CRAs. As such, Article 6a of the Regulation prohibits ownership of 5% or more of the shares or the voting rights in more than one CRA, unless the CRAs concerned are affiliated group companies. Furthermore, the Regulation requires CRAs to disclose if a shareholder with 5% or more of the shares or voting rights holds 5% or more of a rated entity and prohibits the CRA from rating if a shareholder of a CRA with 10% or more of the capital or voting rights simultaneously holds 10% or more of a rated entity. Interestingly, the Regulation does not contain any specific rules with regard to the system of the paying issuer which has been criticized as one of the main reasons for alleged conflicts of interests.

Amendment No. 5: Accountability of CRAs for their ratings by establishment of a civil liability regime

From all the amendments, the most significant and far-reaching one appears to be the establishment of a **civil liability of CRAs** for the ratings issued by them. In this regard, the newly inserted Article 35a of the CRA II Regulation stipulates that where a CRA has committed, intentionally or with gross negligence, certain infringements listed in an Annex to the Regulation, an investor or issuer may claim damages from the CRA for damage caused to it due to that infringement.

The relevant infringements are – although mostly of organizational and procedural nature – manifold and can concern infringements related to conflicts of interests, organizational or operational requirements or derive from the violation of disclosure duties. As such, it can be an infringement if a CRA does not use adequate rating methodologies or data for its rating or does not monitor its ratings on a regular basis. As to the limitation of liability to gross negligence, it is being acknowledged in the considerations for the Regulation that this standard of fault and the limitation is appropriate because the activity of CRAs involves a certain degree of assessment of complex economic factors and the application of different methodologies which can lead to different rating results, none of which can be considered as "incorrect".

With regard to the potential claimants, the Regulation provides for a liability of the CRAs vis-à-vis investors as well as issuers to claim damages from CRAs for the losses suffered. As a precondition for a damage claim, an investor must prove that it reasonably relied in accordance with Article 5a (1) of the Regulation or otherwise with due care, on a credit rating for its decision to invest into or hold onto a financial instrument. Article 5a (1) of the Regulation determines that certain investors, such as credit institutions, investment firms and insurance companies must undertake their own credit risk evaluation and not exclusively and automatically rely on ratings when evaluating the credit-worthiness of a company or financial instrument. Other investors must prove their reliance on the rating with due care while this term has not been defined in the Regulation, but must be interpreted in accordance with the governing national law. Issuers claiming damages under Article 35a of the Regulation, in return must prove that the rating refers to them or their financial instruments and that the infringement is not to be attributed to the fact that the issuer provided incorrect or misleading information to the CRA directly or by public disclosure.

As a further precondition for a damage claim, Article 35a of the Regulation requires that the infringement had an impact on the outcome of the rating. This means that the result of the rating procedure must have been modified due to the violation of duties listed in Annex III to the Regulation. Furthermore, liability under this provision requires a causal link between the infringement and the damage of the investor or issuer.

In accordance with general procedural rules, Article 35a (4) of the Regulation determines that the investor or issuer has the burden of proof for the circumstances for its claim and must present accurate and detailed information indicating that the CRA has committed an infringement of the Regulation, and that such infringement had an impact on the credit rating issued. Thus, the Regulation as resolved by the European Parliament and the Council has not adopted a reverse burden of proof which had initially been proposed by the Commission. However, when assessing the requirement of exact and detailed information concerning an infringement by the CRA, the competent national court must take into consideration that the investor or issuer may not have access to information which is in the sphere of the CRA only. This reduction of the standard to the substantiation of the plaintiff's submission leads to higher requirements for the substantiation of the contesting of an infringement by the CRA which will have to comment comprehensively why it thinks not to have infringed its obligations.

As regards a limitation of liability, the Regulation as a matter of law does not establish liability for simple negligence. Furthermore, pursuant to Article 35a (3) of the Regulation, the liability for intent and gross

negligence may be limited to the extent that such limitation is "reasonable and proportionate". However, the Regulation does not define these terms, but leaves their interpretation with the relevant national law. In this regard, the final text of the Regulation once more has adopted a less strict approach than the Commission's initial draft which explicitly excluded any possibility to limit the CRAs' liability. With a view to the practical consequences of the possibility of limitation, liability can easily be limited where the CRA has a contractual relationship with the Issuer or the investor. However, it is questionable whether the CRA will be able to establish such limitation vis-à-vis investors acting as third parties with whom the CRA does not have any direct relationship. In this regard, CRAs will have to create opportunities to bind third parties on their terms and conditions and respective disclaimers on a limited liability to the extent possible.

Finally, while the Regulation aims to establish a uniform civil liability regime, it is noticeable that it leaves the interpretation of central terms, such as *damage, intent* or *gross negligence* within Article 35a to the respective applicable national law pursuant to the relevant provisions of international civil law. In addition, according to the Regulation, the introduction of the new civil law basis for damage claims does not exclude other liability claims in accordance with national law. Whether or not CRAs in future will be held accountable for their actions will therefore also depend on the relevant national laws and not be determined by the Regulation only.

First voices raised regarding the new rules

As an initial reaction, the new rules for credit ratings have been perceived as showing sensible approaches regarding the regulation of CRAs by addressing the issue of conflicts of interests and the rating of sovereigns. However, it is held that a critical overall assessment of the new regime does not appear to have the potential to achieve the objectives as set out by the European authorities. This also applied to the newly established liability of CRAs for their ratings which in view of some authors has not been sufficiently determined with regard to its requirements and interpretation so that a further reform of the Regulation on CRAs might become necessary.[5] It has in particular been criticized that a number of existing difficulties in asserting damages under the new liability regime would continue to remain under the Regulation as resolved which probably had been eliminated in case the Regulation had become effective as proposed by the European Commission.[6] All in all, it is doubted that the adopted Regulation can constitute an efficient model of future European harmonization of regulation of the CRAs' activities.

Conclusion

In fact, the new rules, although introducing several amendments with an impact on the business of CRAs, are not as far-reaching as they seem and have been presented by the European legislator at the first sight. Even though CRAs are requested to provide for transparency and quality of their rating process and ratings and guarantee an independent assessment of issuers and financial instruments, the amendments contained in the new Regulation will not significantly affect their business. That is particularly the case as the final text of the Regulation remains below the stricter rules as demanded by the European Commission in the initial draft Regulation. Endorsement can also be given with regard to the newly established liability for ratings issued by the CRAs for several reasons: the requirements for infringements listed in the Regulation are rather of organizational nature and not likely to be fulfilled by the leading CRAs which have already implemented adequate measures for their ratings on the basis of the IOSCO rules. Moreover, it will remain with the responsibility of the investor to present and prove that the CRA has committed intentionally or with gross negligence an infringement under the Regulation, which as a further precondition must have had an impact on the result of the rating. As an equivalent to the general objective of the Regulation to reduce overreliance on ratings and to strengthen a responsible use of credit ratings, the investor first must assess the rating with due care before it can claim damages from the CRA. Finally, it remains with the national laws to interpret several of the terms and standards of liability so that it appears to be a long way until a uniform liability under EU law is established and applied to CRAs.

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[1] This article ties in with the article „How credit ratings resemble the weather forecast: a European approach", published in the IBA European Regional Forum Newsletter No. February 1, 2012, page 9 et seq.

[2] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

[3] Regulation (EU) No 462/2013 of the European Parliament and of the Council of May 21, 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

[4] *Cf.* a press release of the European Commission of June 18, 2013, http://europa.eu/rapid/press-release_IP-13-555_en.htm?locale=en.

[5] Cf. Deipenbrock, *Der Stein des Sisyphus? – Die zweite Reform der europäischen Verordnung über Ratingagenturen*, RIW 2013, 1.

[6] Cf. Wojcik, *Zivilrechtliche Haftung von Ratingagenturen nach europäischem Recht* [Civil liability of rating agencies under European law], NJW 2013, 2385. The author of the publication is a member of the Legal Service of the European Commission.

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