INTRODUCTION

- Pertinent and symbolic choice of topic: **1st EU legislation** approved since start of crisis.

- **congratulate Rapporteur Gauzes** for courage and leadership in difficult climate and under great time pressure

- Global nature of rating industry and use of ratings made it **ideal topic for SIFMA** as global capital market organisation representing broad range of users of ratings in EU, US and Asia. We formed a global investor led **Task Force** to address ratings related causes of the crisis - issued recommendations in July last year, several of which we are pleased to see reflected in the EU regulation, eg transparency and disclosure.

- Right that the Regulation focuses on **restoring confidence**, which is its overarching objective. In December, we issued a global report on “restoring investor confidence in the global securitisation market”. We asked over 600 market participants to rank in order of priority out of 16 issues what they saw as the most urgent need for change: restoring confidence in CRAs came 2nd, only just behind enhancing disclosure and standardisation of info.

- Applaud **global leadership** that our EU institutions have showed in this area and are showing in others. We understand the benefits that well designed regulation can bring to markets. Regulation plays significant role in shaping market patterns and participants' behaviours.

- That's the undercurrent to my **topic for today**: “CRAs and their role in the future regulatory framework”. Will the new framework change the way CRAs currently operate and the way markets use their ratings?

- The Regulation has just been approved, not yet come into EU law, and developed without impact assessment, so early days and **hard to predict**. And as the French poet Paul Valery once said: “the problem with our times is that the future is not what it used to be”! But judging by the number of members who attended an update call we organised last Friday, over 60, there is clearly a sense in the industry that something happened, **something will change**.

- After I quickly summarise the new regulation I will highlight what I believe to be the main impacts of the new regulation, as it is impacts that bring about change, depending on their severity.

KEY FEATURES OF THE REGULATION

- Regulation establishes **common framework** that seeks to ensure ratings issued, or used for regulatory purposes (eg CRD), in EU, and the EU CRAs that issue them, are subject to (1) direct supervision in EU, and (2) strict conduct of business rules for CRAs. These are the **2 pillars** underpinning EU Comission’s objective of restoring confidence in CRAs and their ratings in EU.

- Easiest way of building **1st pillar, direct supervision**, is to require EU market participants to only use ratings issued by CRAs registered in EU. This is therefore the basis of the regulation. And it contains detailed procedures for registration via CESR and the organization of supervision via colleges of supervisors.
Rating industry being global, this raises question of treatment of companies/instruments rated outside of EU but in which EU based investors invest or which EU banks use for capital relief purposes. Regulation offers 2 avenues, distinguishing between global CRAs (eg S&P/Moodys/Fitch) and smaller CRAs:

- **Global CRAs**: EU office can “endorse” rating issued by one of its non-EU offices, subject to a number of conditions. Most significant is obligation on EU CRA to demonstrate to its EU regulator that its non-EU office conducts its ratings activities in a manner that is “at least as stringent” as what the EU Regulation requires.

- **Small CRAs** (no EU presence) must be “certified” by the EU. Again, a number of conditions must be satisfied, incl EU Commission must decide that regulatory framework in the small CRA’s country is “equivalent” to the EU’s.

As to the 2\(^{nd}\) pillar, strict conduct of business rules, Regulation imposes detailed requirements on CRAs to avoid/manage conflicts of interests, ensure the quality and integrity of their ratings, enhance the transparency of their processes and to make appropriate disclosures.

- Much of them reproduce the requirements of an existing code of conduct for CRAs developed by IOSCO, the global body of regulators, over the recent years, and which the CRAs (at least the larger ones) had already adopted.

- But Regulation also contains additional different or new requirements eg use specific symbol for SF ratings, require CRA to withdraw existing ratings in certain circumstances, and perhaps the biggest difference, specific requirements re CRA governance structure.

Timing: CRAs must implement and register latest 9mths after Regulation enters into law (expected between July-Oct). 12 mths after entry into force, market participants can only use ratings issued or endorsed by EU registered or certified CRAs; Endorsement applies from registration of a CRA, but conditions re cooperation agreements and non-EU jurisdictions to have CRA regulatory/supervisory framework in place don’t start until 18 mths after entry into force.

**MAIN IMPACTS OF THE REGULATION**

1. **Impact on structure of rating industry.** Currently 2 main characteristics: global & oligopolistic.

- Regulation applies strong pressure on CRAs to establish presence in EU, raising question over possible fragmentation of global rating activities and impact on users’ ability to use rating as global benchmark.

- Fragmentation risk reduced if EU Regulation becomes global standard – an objective of EU

  - Should work out for global CRAs - will likely adopt global standards based on EU regulation so the EU office can “endorse” their non-EU offices activities as “as stringent as” what EU requires. Welcome mechanism that limits the disruption to industry in its ability to continue to use ratings as a global benchmark for risk assessment. But will only work if standards imposed by EU politically acceptable and legally enforceable in other jurisdictions. Eg, the prohibition on CRAs from disclosing a rating action until 12 hours after it has informed the issuer of its decision to take action is against SEC rules on market manipulation in the US.

  - For small CRAs with no EU presence, unlikely to pass the “certification” test since this requires an equivalence assessment by the EC and (1) CRA regulatory frameworks around
the globe are only emerging or being updated; (2) we know from experience equivalence assessments take a lot of time. This means in the meantime that the ratings of a small CRA can’t be used for regulatory purposes in EU unless it sets-up in EU – also unlikely.

- **Effect** could be a reduction in relevance of the small CRAs or, as an investor on my last Friday call noted, further enhance the market share of the 3 main CRAs. In addition, small CRAs will find it difficult to meet the detailed conduct of business and organisational requirements of the Regulation (despite the few exemptions granted). So a very possible outcome is a **strengthening of the current oligopoly**.

- Not surprising since increased competition in rating industry not an objective of the Regulation. Hence the report on concentration in the rating industry which the Regulation calls for is welcome.

2. **Impact on markets, issuers and users**

- On **positive** side, Regulation makes a significant contribution to the objective of restoring confidence in CRAs, which should have a positive knock-on effect on restoring confidence in credit markets
  
  ▪ Involvement of regulators and the detailed requirements on transparency, integrity, quality, conflict management, with additional ones for SF, send a strong positive message to users.

  ▪ There is a question mark over whether it may go too far to the point of relaxing investors’ due diligence when one of its objectives is to reduce investor reliance on ratings.

- Obvious and immediately visible impact is significant increase in **cost** of doing business for CRAs, and thus for issuers and users of rating. Arising from (i) foreign CRAs having to set up in EU; (ii) much heavier organisational requirements on CRAs, in partic. new governance requirements; (iii) new fees imposed by regulators for CRA surveillance; (iv) systems changes resulting from the requirement to use specific symbols for SF ratings.

- But **more concerning** are possible impacts to market instability and to innovation

  ▪ **Market instability/uncertainty** could come from 4 sources: (i) stigma risk attached to the requirement for specific rating symbols to be assigned to SF products, causing sell offs of securities into an already distressed market; (ii) uncertainty arising from EU supervisors’ power to withdraw CRA registration, prohibit issuance of ratings, or suspend regulatory use of ratings; (iii) unclear interaction between this Regulation and the CRD: in partic re treatment of ratings of foreign CRAs currently recognised as ECAIs under the CRD who don't/can’t register under the Regulation; (iv) 12 hr delay between rating action and public disclosure of such action

  ▪ **Limitations to market innovation**, eg supervisor could require a CRA to withdraw existing rating after making a subjective determination that “the complexity of the structure of a new type of financial instrument…raises serious questions”. Whilst the industry is certainly guilty of having pushed financial engineering too far, it is important, for competitiveness of EU, that EU regulation provides for the ability for continued controlled innovation.

3. **Impact on future of global regulatory convergence**

- Since the turn of the century and until the onset of the crisis, regulators in EU and US (but also globally) had put much effort into working together to reduce their regulatory differences and developing tools to be able to rely on each other’s regimes, realising that these efforts were key
to global financial markets integration.

- A worrying feature of the EU CRA regulation is the **U-turn** taken in approaching recognition of non-EU regulatory regimes, using terms such as “as stringent as” and “certification” which in effect amount to pressurising other countries in adopting copy cat legislation. Showing global leadership is an opportunity that EU should seize, is seizing, but must be inclusive in order to succeed. If each country seeks to apply its own standards on other regulators/markets, then we do have a serious fragmentation issue.

- The EU approach reflects an understandable lack of **trust** towards the US. But rebuilding trust is critical to the success of other important EU and global initiatives, in particular systemic risk supervision and crisis-management, and critical to restoring market confidence more broadly. As many G20 leaders have stated, this is a global crisis that requires global solutions.

- The EU parliament has an important role to play in ensuring a successful outcome and should be encouraged to strengthen its dialogue with 3rd country legislators.

**CONCLUSION**

- Strong, positive signal to users of ratings which should assist objective of restoring confidence in CRAs and markets more broadly

- Need to watch closely impact on structure of rating industry, on markets and on ability to achieve future global regulatory convergence

- Next big debates on rating industry agenda with potential for more fundamental changes are upcoming EU Commission reports on (i) creation of an EU public CRA; (ii) issuer vs investor-pays model, which the Regulation calls for.

La Fin

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