MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular to the financial services industry on the Third Credit Rating Agencies Legislative Package

1. Background

In September 2009, the European Parliament and the EU Council adopted the regulation on credit rating agencies (1060/2009), hereafter referred to as the "CRA regulation". This established a framework for the regulation of credit rating agencies in the European Union. An amendment to the CRA regulation was made in the year 2011, in particular to establish the European Securities and Markets Authority ("ESMA") as the financial supervisor responsible for the registration and on-going supervision of credit rating agencies.

In November 2011, the European Commission tabled a new legislative proposal on credit rating agencies ("the CRA III proposal")[1]. The final compromise text of the CRA III Regulation was adopted by the European Parliament during the plenary session held on the 16th January 2013, and is currently awaiting the formal approval of the EU Council. The new rules will enter into force twenty days following their publication in the EU official journal.

2. Objectives of the CRA III Regulation

The CRA III Regulation complements the current regulatory framework for credit rating agencies. It introduces a common regulatory approach which enhances the integrity, transparency, responsibility, good governance and independence of credit rating agencies, thereby contributing to the smooth functioning of the internal market, while achieving a high level of investor protection. In particular, the CRA III Regulation aims at:

- Reducing the overreliance by financial institutions on credit ratings;
- Improving the quality of ratings of sovereign debt of EU Member States;
- Enhancing the accountability of credit rating agencies;
- Reducing conflicts of interest of credit rating agencies due to the "issuer pays remuneration model"; and
- Increasing the transparency of credit ratings by requiring their publication on a European Rating Platform.

[1] The CRA III proposal is composed of one Regulation, which relates to amendments to the CRA Regulation that is currently in force, and to one Directive. The CRA III Directive amends Directive 2003/41/EC (the IORPS Directive), Directive 2009/65/EC (the UCITS Directive) and Directive 2011/61/EU (the AIFM Directive).

3. Reducing overreliance on credit ratings

On the 20th October 2010, the Financial Stability Board (FSB) endorsed principles to reduce the authorities' and financial institutions' reliance on credit ratings. In this regard, the European Union is working towards reviewing references to external ratings in Union law, with a view to eliminating all such references by 2020 whenever they trigger or have the potential to trigger sole or mechanistic reliance on such ratings. In the medium term, the European Union will be evaluating further actions to take ratings out of financial regulation and to eliminate risk-weighting of assets through external ratings.

The CRA III Regulation supports the international objective of reducing the overreliance on credit ratings and requires credit institutions, investment firms, insurance and reinsurance undertakings, institutions for occupational retirement provisions, management and investment companies, alternative investment fund managers and central counterparties to make their own credit risk assessment for the purpose of assessing the creditworthiness of an entity or financial instrument.

Competent authorities in charge of supervising these undertakings shall take into account the principle of proportionality when monitoring the adequacy of their credit assessment processes and the extent of use of contractual references to credit ratings. In particular, competent authorities shall ensure that the credit assessment processes of financial institutions do not rely mechanistically on credit ratings[2].

4. Reliance provisions in other EU Directives

On the 16th January 2013, the European Parliament also approved at its first reading the amendments to Directive 2003/41/EC, Directive 2009/65/EC and Directive 2011/61/EU (the CRA III Directive), which are aimed at encouraging institutions for occupational retirement provision, management or investment companies of undertakings of collective investment in transferable securities and managers of alternative investment funds, to limit their use of credit ratings in their investment policies, taking into account the nature, scale and complexity of their investments.

The position taken by the European Parliament in relation to these amendments is subject to the approval of the EU Council. The CRA III Directive amending these three Directives will enter into force on the twentieth day following its publication in the EU Official Journal. Transposition of these amendments must be effected by Member States within eighteen months of the date of entry into force of the CRA III Directive.

[2] Financial institutions may refer to *the FSB's Principles for Reducing Reliance on CRA Ratings* for guidance on the actions that may be undertaken by financial institutions for the purpose of reducing overreliance on credit ratings.

5. Specific reliance provisions in the Fourth Capital Requirements Directive ("CRD IV")

Under the current Capital Requirements Directive (Directive 2006/48/EC and Directive 2006/49/EC), those credit institutions and investment firms applying the Standardised Approach to calculate own funds requirements for credit risk rely on the credit ratings issued by credit rating agencies. Reliance on credit ratings is also made by these institutions when calculating own funds requirements for specific risk of debt instruments in the trading book.

On the 20th July 2011, the European Commission proposed changes to the current Capital Requirements Directive, in order to strengthen the stability of the financial system. In their proposal, the European Commission introduced new measures, with the intention to limit the extent of use of credit ratings by certain credit institutions and investment firms, in line with the Financial Stability Board's objective to remove or replace references to credit ratings in laws and regulations, wherever possible. In particular, article 76 of this proposal states:

*"Competent authorities shall ensure that institutions take appropriate steps to develop internal ratings based approaches for calculating own funds requirements for credit risk where their exposures are **material in absolute terms** and where they have at the same time a **large number of material counterparties**."*

A similar provision is proposed in relation to the calculation of the specific risk of traded debt instruments.

The European Council supported the measures introduced by the European Commission in the CRD IV to reduce the institutions' overreliance on credit ratings but it proposed to restrict these provisions to large institutions, taking into account the nature, scale and complexity of the activities of the institutions. On the other hand, the European Parliament proposed to apply the principle of proportionality to credit institutions and investment firms, only with respect to their calculation of the specific risk of debt instruments in the trading book.

The European Commission, the EU Council and the European Parliament are still considering these proposals.

The MFSA encourages financial services licence holders to familiarise themselves with the CRA III proposal, particularly with respect to the new overreliance provisions, as this may have an impact on their business and compliance procedures.

Contacts

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