## Credit Rating Agencies on the Watch List

Analysis of European Regulation

RAQUEL GARCÍA ALCUBILLA AND JAVIER RUIZ DEL POZO



## Contents

List of Tables		
List of Abbreviations		
Note to the Reader	xvi	
1. Introduction	1	
1.1 A History of Ratings and the Role of Rating Agencies	1	
1.1.1 Financial Markets Prior to Rating Agencies	1	
1.1.2 The Predecessors of Rating Agencies	2	
1.1.3 The Rise of Rating Agencies	4	
1.1.4 Role of Rating Agencies	5	
1.2 Rating Industry	6	
1.2.1 Characteristics	6	
1.2.2 Worldwide	7	
1.2.3 Europe	10	
1.3 Use of Ratings	11	
1.3.1 Use by Market Participants	12	
1.3.2 Use in Private Contracts	13	
1.3.3 Use in Regulation	16	
1.4 Rating Process	18	
1.4.1 Rating Process for Traditional Ratings	18	
1.4.2-Rating Process for Structured Finance Instruments	23	
2. Financial Crisis: Global Regulatory Reaction	27	
2.1 Deficiencies in the Rating Industry	27	
2.1.1 Introduction	27	
2.1.2 Failures in Integrity	28	
2.1.3 Failures in Reliability	28	
2.1.4 Failures in Transparency	30	
2.1.5 Lack of Competition	30	
2.2 Global Initiatives	32	
2.2.1 Introduction 2.2.2 G-20	32 33	
2.2.2 G-20 2.2.3 Financial Stability Board	34	
2.2.4 IOSCO	36	
2.2.5 Over-reliance on Ratings	41	
2.2.5 Over-remance on Natings	41	
3. Analysis of the EU Credit Rating Agencies Regulation	47	
3.1 Background	47	
3.1.1 European Commission's Communication	47	
3.1.2 ESMA's Reports on Rating Agencies	48	
3.1.3 European Commission's Regulation Proposal	49	

x Contents

	3.2	Supervisory Structure	51
		3.2.1 Colleges of Supervisors	51
		3.2.2 ESMA	53
	3.3	Definitions and Concepts	58
		3.3.1 Credit Rating and Rating Category	58
		3.3.2 Credit Rating Activities and Ancillary Services	. 64
		3.3.3 Credit Rating Agency and Group of Rating Agencies	65
		3.3.4 Persons Involved in Rating Activities	67
		3.3.5 Rated Entities and Rated Instruments	68
		3.3.6 Other Definitions	70
	3.4	Scope	71
		3.4.1 Ratings under the Scope	71
		3.4.2 Ratings and Credit Scores Outside the Scope	75
	3.5	Use of Ratings for Regulatory Purposes	83
		3.5.1 Introduction	83
		3.5.2 Basel and Capital Requirements Directive	85
		3.5.3 ECAIs Recognition Process under the CRD	87
		3.5.4 Eligibility as Collateral by European Central Bank	97
	3.6	Registration Process and Requirements	99
		3.6.1 Rating Agencies Operating in Europe in 2010	99
		3.6.2 Scope for Registration	100
		3.6.3 Registration Process	100
		3.6.4 Withdrawal of Registration	107
		3.6.5 Notification and Publication	108
		3.6.6 Material Changes to Initial Conditions	109
	3.7	Supervision and Enforcement	110
		3.7.1 Introduction	110
		3.7.2 Supervision by ESMA	113
		3.7.3 Infringements	119
		3.7.4 Sanctioning Regime	120
	3.8	Substantive Requirements	130
		3.8.1 Organization and Governance	130
		3.8.2 Business Activities and Resources	143
		3.8.3 Independence and Conflicts of Interest	165
		3.8.4 Methodologies, Models, and Key Assumptions	183
		3.8.5 Disclosure and Presentation of Ratings	200
		3.8.6 Transparency of Rating Agencies' Activities, Policies,	
		and Procedures	. 215
Į.	Use	e of Non-EU Ratings in the EU	227
		Procedures Set Out by the CRA Regulation	228
		4.1.1 Systemic Importance	229
	4.2	Endorsement	229
		4.2.1 Scope	229
		4.2.2 Conditions	230
		4.2.3 Responsibility of the Endorsing CRA	230
		4.2.4 Application for Endorsement	231

Contents	xi
0011101110	111

	<ul><li>4.2.5 Approval of Endorsement and Endorsing Activity</li><li>4.2.6 Changes to Endorsing Regime</li></ul>	233 234	
4.3	Certification Based on Equivalence	234	
	4.3.1 Scope	234	
	4.3.2 Process	235	
	4.3.3 Application for Certification	236	
	4.3.4 Sanctioning Regime	237	
	4.3.5 ESMA's Methodology to Assess Equivalence	238	
	4.3.6 ESMA's Advice on the Equivalence Between the US and EU		
	Frameworks	239	
	4.3.7 European Commission's Equivalence Decision on Japan	241	
4.4	Relationship Between Endorsement and Certification Based on		
	Equivalence	241	
4.5	Cooperation Arrangements	244	
	ure Developments	245	
5.1	Rethinking Business Models	246	
	5.1.1 Investor-Pays Model	247	
	5.1.2 Public Utility Model	249	
	5.1.3 Payment-Upon-Results Model	251	
	5.1.4 Hiring Agent Model	251	
	Over-Reliance	253	
	Competition	254	
	Civil Liability	255	
	Sovereign Ratings	257	
5.6	Global Consistency in Regulation and Oversight of Rating		
	Agencies	258	
	5.6.1 Regulatory Consistency	258	
	5.6.2 Oversight Coordination	260	
5.7	Overall Conclusions	260	
Appen	dices		
Ap	pendix 1. The European System of Financial Supervisors	263	
	pendix 2. ESMA's Governance Structure and Resources	266	
Ap	pendix 3. Mapping Factors Under CRD	268	
Ap	Appendix 4. US Legislation on CRAs		
	Appendix 5. Japanese Legislation on CRAs		
Glosso	irv	283	
	Glossary Bibliography		
Index			
-110000		291	