Association for Financial Markets in Europe Response to Consultation Paper: Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Regulation 1060/2009

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1. Introduction

1.1.1 The Association for Financial Markets in Europe (AFME) and its members are extremely concerned by the approach proposed in the Consultation Paper which is not required by the Regulation and which has the very real potential to prohibit the use of credit ratings for regulatory purposes from major non-EU jurisdictions, including the US. This would result in multiple increases in regulatory capital requirements and significant market distortions. It is not clear to us that the potential impact of the proposals in the Consultation Paper are fully appreciated and we consider that the effects are likely to be of a magnitude significantly greater than expressed in the impact study. It is for this reason we hope that it will be possible to meet with ESMA shortly to discuss how best to resolve our concerns.

2. Interpretation of the Endorsement Regime

2.1.1. The main focus of the consultation paper is the presentation of ESMA's interpretation of Article 4(3) of the Credit Rating Regulation 1060/2009 on the application of the endorsement regime.

2.1.2. It is stated in paragraph 24 of the consultation paper that ESMA's proposed current interpretation is that to allow the endorsement of credit ratings issued by a credit rating agency in a third country, it is necessary for the requirement for the ratings to have been issued under conditions 'as stringent as' Articles 6-12 of the Credit Rating Regulation to be met through the *legal framework or under regulation of the third country*.

2.1.3 This differs significantly from the interpretation of the Regulation that our members together with other trade bodies and interested parties have reached in the light of the text agreed when the Regulation was adopted and the discussions that took place at that time. Our interpretation, which has been communicated to ESMA before, is that the endorsement process was created deliberately as a flexible mechanism to allow the continued use of ratings from non-EU jurisdictions subject to the relevant EU credit rating agency validating that the <u>conduct of credit rating activities</u> by the third country credit rating agency would fulfil requirements at least as stringent as the rules in the EU credit rating agency regulation. Thus this test, whilst a strict one, can be applied on a 'self-imposed' basis instead of there being the need for the 'as stringent as' requirements to be established by law or regulation. This interpretation is further highlighted in the own initiative report 'Credit rating agencies: future perspectives' prepared by MEP Wolf Klinz, where the Commission is reminded of the dual approach established by the Regulation between 'endorsement' and 'certification based on equivalence'. In particular, it is stated in the report that the intention of the endorsement regime was to allow external credit ratings from third countries to be used in the EU if clear responsibility was attached to an endorsing CRA.

2.1.4 The interpretation proposed by ESMA essentially eliminates the flexibility built into the endorsement requirements in the regulation and requires a full equivalence determination by ESMA that the requirements in place for the conduct of credit rating activities in third country jurisdictions are 'as stringent as' EU regulation before an EU credit rating agency can endorse a rating issued by its non-EU office.

2.1.5 Our members disagree with and do not understand ESMA's reasoning in the consultation paper behind the proposed interpretation of Article 4.3(b) which would only refer to requirements established by law or by regulation: in particular, Articles 4.3(f) and 4.3(g) do not imply that the *regulatory regime* in the third country jurisdiction needs to be 'as stringent as' the requirements set out in Articles 6-12, and that the requirements could not be met on a voluntary basis. In addition, Article 3(b) supports our members' interpretation through reference to the CRA itself meeting the 'as stringent as' requirements.

2.1.6 In the Consultation Paper it is suggested that it might not be consistent to require for endorsement that the third country regulatory system provides for authorisation/registration and supervision of credit rating agencies, and that at the same time the requirements 'at least as stringent as' can be also met on a voluntary basis: this is not the case because there may be limits to what authorisation/regulation provides for country by country. In addition, the reference in Article 4.3(g) to the regulatory regime does not in any way indicate that the 'at least as stringent as' requirements can only be established through law or regulation.

2.1.7 Finally, the Regulation does not state that local legal and/or regulatory rules in a third country cannot be 'topped-up' by policies and procedures put in place by the third country credit rating agency or the EU registered, endorsing credit rating agency. Moreover, looking forward, as standards evolve in the EU changes will need to be tracked by CRAs so that the issues raised can be addressed, to which the application of 'at least as stringent' requirements on a 'self-imposed' basis is well suited. If changes can only be recognised by amendments to law or regulation in third country jurisdictions, the confidence of firms as to their on-going ability to use ratings would be eroded, serving as a source of further market volatility.

3. Implementation Issues

3.1.1 It is our understanding that where an EU CRA has endorsed a third country CRA, it is then necessary for the CRA to demonstrate to ESMA that the 'as stringent as' requirements have been met. This can be achieved through the provision of relevant information to ESMA or through ESMA being able to collect information concerning the conduct of the third country CRA from a third country supervisory authority. Accordingly, it is set out in the Regulation that there must be appropriate co-operation arrangements between ESMA and the relevant competent authority of the CRA established in the third country. ESMA will then assess whether the relevant aspects of the EU Regulation have been met.

3.1.2 Owing to the rapidly approaching June deadline, there must be a very serious risk that major third country jurisdictions will not have completed work in time to ensure that adequate supervisory arrangements are in place by law or regulation. And even if the 'as stringent as' test was applied on a self-imposed basis, ratings outside the EU would not necessarily be able to be endorsed as the EU competent authorities may not have the necessary co-operation arrangements in place with third countries.

3.1.3 To date, there has been no formal indication as to the jurisdictions from which ratings could be endorsed, and it is not apparent that there has been sufficient consideration of the interaction of the requirements for endorsement with the Capital Requirements Directive or inter-linkages with prudential supervision at member state level. Our members have therefore been unable so far to undertake adequate preparations for the introduction of the new regime.

4. Forthcoming Impact

4.1.1 The serious risk, therefore, is that it will not be possible for banks to continue to use most third country credit ratings for regulatory purposes. We have outlined the effects of this previously in our response to ESMA's call for evidence in January, which are again summarised in the paragraphs 3.1.2 to 3.1.3. Furthermore, our reading of the cost benefit analysis included as part of the consultation indicates that there is no compelling argument for proceeding in the way suggested. Moreover, the European Banking Federation ('EBF') has made some very useful comments on the impact assessment ESMA has completed, with which we are in agreement. We would add also that the cost benefit analysis considers only the implications in relation to the use of the Standardised Approach and IRB for securitisation, and does not comment on trading book implications which would include effects on qualifying debt items and securitisations, the eligibility of collateral and guarantees and the potential follow-on implications for large exposure issues. The analysis also does not take account of potential pricing implications for securities where capital requirements increase and does not consider the potential opportunity costs associated with business and markets that may no longer be available.

4.1.2 The inability to hold third country regimes to be equivalent would make lending to or investment in non-EU sovereigns, financial institutions, and corporates prohibitively expensive for EU banks and securities firms owing to the material increase in regulatory capital requirements associated with not being able to recognise the relevant ratings. For the same reason, there would also be substantial increases in capital requirements associated with securitisations both in the trading and non-trading books together with significant implications for the eligibility of financial collateral and guarantees for regulatory capital and large exposures purposes. By way of illustration, banks using the standardised approach lending to or investing in investment grade corporates from the US would face a five-fold increase in capital required if the applicable ratings could not be endorsed. Meanwhile, investments held through securitisations, which might currently be rated at 100%, could need to be treated as a capital deduction – a twelve-fold capital increase.

4.1.3 These impacts may in turn lead to unintended consequences for the management of liquidity in Europe, particularly through the implications for the constituents of firms' liquid asset buffers where the use of internal ratings are not permitted and through the increased discounts applied to other debt securities in firms' asset portfolios where ratings can no longer be used and the associated impact this would have on repo transactions. The inability of firms to use ratings from third country jurisdictions would also lead to increased concentration risks across the market and the non-viability of some business models.

5. Concluding remarks and request for a meeting

5.1.1 We have stated in the past that the endorsement regime needs to be deployed in a way that enables firms to maintain the existing use of third country credit ratings without causing disruption to regulatory capital requirements or liquidity, resulting in wider market distortions. Given the very short timeframe before the expiry of the transitional period in June, it is now imperative that steps are taken at senior levels to address the impending impact of firms not being able to continue to use ratings from major third country jurisdictions.

5.1.2 We have also expressed our view in previous correspondence that the Regulation was carefully drafted to provide for the well-controlled use of worldwide ratings, and the 'gold plating' of interpretations relating to endorsement is not helpful in the current situation. There is still time for ESMA to change the interpretation of the regulation suggested in the Consultation Paper and this, together with establishing the necessary co-operation agreements with third countries and the possible extension of the transitional period, appears the only way of mitigating the pending difficulties and market/economic disturbance.

5.1.3 Given the seriousness of this issue and the scale and breadth of the impending negative impacts on firms and markets more widely, we request a meeting with the relevant authorities to explore solutions as soon as possible. We should note that we have written separately to Carlos Tavares.

5.1.4 AFME, finally, wishes to express its agreement with the response submitted to this consultation by the EBF, with which we have liaised in preparing this response.