

Call for Evidence: on the criteria for endorsement (Article 21(2) (a) of the draft amended CRA Regulation)

A submission by the Association for Financial Markets in Europe

1. Introduction

- 1.1.1. The Association for Financial Markets in Europe ('AFME')¹ is pleased to respond to the European Securities and Markets Authority's ('ESMA's') call for evidence on the criteria for endorsement (Article 21 (2)(a)) of the draft amended CRA regulation. Owing to the limited time available to respond, so far member firms have not yet been able to share with us the results of any work that they have been undertaking to quantify the potential impacts on their capital requirements under the assumptions set out in the questions posed or to obtain the breakdowns requested.
- 1.1.2. We understand that some AFME member firms will respond directly to this call but, given the extent of the challenges remaining and their implications for EU banks and securities firms, our members have asked us to summarise their key concerns. We would be pleased also to discuss or provide ESMA with further information in relation to this response, if this would be helpful. We certainly suggest that a properly constituted impact study be initiated, and co-ordinated through national regulators in the same way that CEBS impact assessments have been constituted in the past.

2. Comments

- 2.1.1. Our understanding is that according to the interpretation set out in CESR's June 2010 guidance, requirements for the oversight and supervision of CRAs in non-EU jurisdictions that are at least as stringent as those set-out in Articles 6-12 would need to be established in law or regulation in those third countries from the expiry of the transition period on 7 June 2011 as, in effect, a preliminary stage to CRA endorsement.

¹ AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

- 2.1.2. There is a significant likelihood therefore that owing to the tight deadlines, some major jurisdictions will not have completed work to ensure that adequate supervisory arrangements are in place and that, in the case of Article 5 recognition decisions, the Commission may not have had sufficient time to complete its determination as to whether jurisdictions have in fact successfully achieved equivalence. In the case of Article 4 endorsements, we agree also that even if an '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.
- 2.1.3. The serious risk, therefore, is that there will be some cases where it will no longer be possible to continue to use external credit ratings for regulatory purposes. It is to be hoped that this consultation will bring to the extent of this problem which we believe, given our members' concerns, to be significant, and will highlight the need for the relevant authorities to co-operate to the fullest extent possible in order to seek to ensure that the required standards are met in time. This involves recognising that the Commission, ESMA and the Member States in Colleges must be resourced to implement the processes envisaged in Articles 4 and 5.
- 2.1.4. We are also concerned that an inability to assess third country CRA regimes as 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. This in turn may lead to unintended consequences for the management of liquidity in Europe, increased credit concentration risks across the market and the non-viability of some business models. This may be complicated further by the instance, particularly in the Asia-Pacific region, of CRA arrangements whereby lead analysts are located in regional hubs and rate firms and debt issues across several economies.
- 2.1.5. In terms of quantification, if one were to assume that the ratings agencies of, for example, the world's largest economy, failed to meet the necessary criteria then banks using the standardised approach investing in that market would see a five-fold increase in capital if investment grade corporates

suddenly became unrated. Furthermore investments held through securitisations, which might currently be rated at around 100% could end up as a capital deduction – a twelve-fold capital increase. Our members are concerned at the tight deadline for this call for evidence and would welcome further time to conduct this impact assessment with greater accuracy, and using the established procedures for conducting assessments of this nature, which are normally co-ordinated via national regulators as we say at the beginning of this note.

- 2.1.6. We had hoped that a possible course of action to mitigate the risks of these unintended consequences might be to seek a flexible approach to assessing equivalence in the early stages of the new regime and to implement a phased approach to the implementation of the full standards. This would have the benefit of ensuring that major jurisdictions could be considered equivalent from June, whilst recognising, though, that further work would need to be undertaken. This would avoid potential market disruption or distortions arising from the authorities' implement inability to complete the work necessary by the deadline due to insufficient resource available. We would be pleased to discuss this possibility with ESMA and the Commission. Alternatively, ESMA may conclude that it should press for legislation extending the transitional period unless it is confident that it is able to ensure arrangements for continued use of third country ratings in the interim.

3. Concluding remarks

- 3.1.1. AFME supports strongly the objective of reforming the regulatory framework and understands the challenges faced by regulators and policy makers. We welcome the commitment to bring forward consultation proposals with a cost benefit analysis but must stress that it is essential that this fully explores the issues given that the consultation period for the Criteria for Endorsement was only ten days which has made a comprehensive response impossible. Owing to the short timeframe before the expiry of the transitional period in June, AFME and its members look forward to a comprehensive consultation paper and an appropriate consultative period, and welcomes the opportunity this will afford to provide detailed feedback and suggestions.

Association for Financial Markets in Europe
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