

*Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.*

## **Response to ESMA Consultation Paper on the Application of the Endorsement Regime under Article 4(3) of the Credit Rating Regulation 1060/2009**

### **Key Points**

- The EBF disagrees with ESMA's legal analysis of the "endorsement" regime and in particular, the interpretation that this regime refers to rules that are established by law or the regulation of the third country. Rather, the Federation firmly believes that the reference to rating agencies' "conduct" leaves the responsibility for endorsement to the endorsing CRA.
- This interpretation has been explicitly confirmed by several Member States, as well as by the European Parliament's Economic and Monetary Affairs Committee in its own-initiative report on rating agencies, as voted on 16 March 2011.
- The EBF is furthermore concerned that ESMA's Impact Assessment seems to underestimate the effects of its endorsement interpretation on banks' regulatory capital requirements and on the markets more widely.. Most importantly, the assessment relies on too little data and not sufficiently substantiated assumptions to provide a representative picture.
- In addition to the legal and political considerations, the European banking industry does therefore also not believe that ESMA's interpretation of the endorsement process would have the aggregate economic advantages that ESMA appears to expect.

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Related documents: ESMA Consultation document: <http://www.esma.europa.eu/popup2.php?id=7514>

## General remarks

The European Banking Federation has repeatedly commented on the interpretation of the regime to “endorse” ratings under Article 4.3 of the Credit Rating Agencies Regulation (cf., e.g., its response to ESMA’s call for evidence on the same issue, of 24 January 2011). As set out by ESMA, this regime has been created as an alternative to the positive assessment of regulatory equivalence by the European Commission and is therefore of major significance to European banks. This does not only concern smaller institutions, but also larger ones which typically use internal assessments for their most significant portfolios, but also use external ratings for at least some other portfolios.

The EBF sets out below its interpretation of the “endorsement” regime and, as requested by ESMA, then comments on ESMA’s Impact Assessment.

## The interpretation of the “endorsement” regime under Article 4.3 of the Credit Rating Regulation 1060/2009

The EBF has in the past repeatedly questioned ESMA’s interpretation of the endorsement process and would like to reiterate its considerations in this respect. This is in particular with respect to subparagraph (b) of Article 4.3, which specifies the following condition for the endorsement of ratings issued outside the EU:

*‘(b) the credit rating agency has verified and is able to demonstrate on an ongoing basis to the competent authority of the home Member State that the conduct of credit rating agencies by the third-country credit rating agency resulting in the issuing of the credit rating to be endorsed fulfils requirements which are at least as stringent as the requirements set out in Articles 6 to 12’.*

The reference made in this provision to the conduct of the non-EU credit rating agency is in clear distinction to the equivalence regime, which refers to ‘legally binding rules’. As a matter of principle, the EBF therefore cannot find itself in agreement with ESMA’s view that the requirements for rules to be “as stringent as” those of the EU CRA Regulation refer to rules that are established by law or the regulation of the third country.

Rather, the endorsement regime was a thoroughly considered political agreement to ensure the high quality of ratings in the EU by way of imposing the responsibility for the ratings issued outside the EU on the rating agencies active in the EU, while avoiding either the duplication of rating processes or an extra-territorial reach of EU legislation.

We see this interpretation shared by the Joint Declaration that was submitted by the United Kingdom, Spain, the Netherlands, Sweden, Austria, Finland, Hungary, and Ireland (subsequently also endorsed by Luxembourg) in the course of the discussions in the autumn of last year to amend the Credit Rating Agencies Regulation, which stated among other things that

*“[ESMA guidelines] are necessary to clarify that endorsement can take place if the third country’s regulatory regime or, in the absence of such regulatory requirements, the credit rating agency itself applies requirements which are at least as stringent as the requirements set out in articles 6-12 of Regulation 1060/2009. The endorsing credit*

*rating agency shall remain responsible to ESMA for compliance with such requirements, in accordance with paragraph 5 of Article 4 of Regulation 1060/2009”.<sup>1</sup>*

Also the European Parliament’s Committee on Economic Monetary Affairs included a clarification of the interpretation of the endorsement regime in its recent own-initiative report (as voted by the Committee on 16 March 2011), which states that:

*“14. Reiterates that Regulation (EC) No 1060/2009 devises two systems to deal with external credit ratings from third countries and that the intention behind the endorsement regime was to allow external credit ratings from third countries deemed non-equivalent to be used in the European Union if clear responsibility was attached to an endorsing CRA”.*

Against the background of this clarification of the legislative intention of the endorsement process, the EBF firmly believes that the underlying assumptions of the present consultation deserve reconsideration.

## ESMA’s Impact Assessment

The EBF is furthermore sceptical about the accuracy of ESMA’s Impact Assessment, notably in view of the following considerations:

- While recognising the difficulty of obtaining meaningful data, the Impact Assessment is almost void of any data to support ESMA’s qualitative considerations. Even for the most fundamental aspects of the analysis such as what would be considered to constitute “high” or “low” costs, there is no specification of ESMA’s classification.
- It is similarly not clear on what basis ESMA has designed its weighting system and the summary, comparing costs and benefits across the different concerned groups.
- The EBF is furthermore sceptical about the relevance of some of ESMA’s qualitative considerations. Notably, the comparison of the assumed costs and benefits of the endorsement regime as interpreted by ESMA should be compared with those that would be applicable under the alternative assumption that it was in the responsibility of the rating agencies themselves to ensure that the stringent criteria of the EU CRA Regulation were applied to ratings issued from outside the EU. Instead, ESMA’s comparison seems to assume that non-EU ratings would alternatively be subject to no qualitative controls at all.
- The EBF is also struck by ESMA’s apparent assumption that third countries could or should be assumed to adopt their own legislation to the rules applied in the EU (e.g. in respect of point 46 of ESMA’s CP, “(t)he functioning of the endorsement mechanism as set out in CESR’s Guidance may require changes to the national legislations in certain third countries. In some circumstances, these changes may not be feasible or rapid enough to meet the timeline defined by the Regulation.” The EU rules on rating agencies go significantly beyond the agreement reached in the International Organization of Securities Commissions (IOSCO). There is thus no reason to assume that these rules would in this form be copied by other jurisdictions.

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<sup>1</sup> 2344th meeting of the Permanent Representatives Committee held in Brussels on 8, 10 and 13 December 2010, Addendum to the Summary Record  
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- In addition, the EBF notes that ESMA seem to disregard the new provisions of the Basel III framework for the “Incorporation of IOSCO’s Code of Conduct Fundamentals for Credit Rating Agencies”<sup>2</sup>. On the External Credit Assessment Institution (ECAI)’s recognition process, Basel III requires the following: *“National supervisors are responsible for determining on a continuous basis whether an external credit assessment institution (ECAI) meets the criteria listed in the paragraph below. National supervisors should refer to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies when determining ECAI eligibility. The assessments of ECAIs may be recognised on a limited basis, e.g. by type of claims or by jurisdiction. The supervisory process for recognising ECAIs should be made public to avoid unnecessary barriers to entry.”*
- Questionable is also the assumption, in point 52 of the CP, that “the agencies could adjust their processes and organization in the medium/ long term in order to recover the supply of [ratings issued outside the EU] in the Community”. Rather, this would require either a relocation of analysts, likely further away from the rated entities; or the appointment of new analysts with an associated loss of expertise. European banks do not believe that either approach would be likely to improve the quality of the ratings.

In summary, therefore, and in addition to the legal and political arguments outlined in the first part of this paper, the EBF does not believe that ESMA’s interpretation of the endorsement regime would be economically more beneficial than the interpretation according to which the responsibility for the endorsement of ratings issued outside the EU, subject to meeting the same quality standards as for ratings issued from within the EU, was to lie with the rating agencies themselves.

On the contrary, the EBF would reiterate its concerns about the economic effects of the endorsement interpretation as it is currently being advocated by ESMA. As it stands, ESMA’s interpretation would forbid banks to use ratings issued in the largest number of non-EU countries, possibly including the US. European banks feel that the potential impact of this interpretation, in terms of banks’ regulatory capital requirements and the related impact on the market as a whole, seems to be underestimated in ESMA’s analysis. Indeed, there is a risk of a real market disruption were ESMA to uphold this interpretation, which would greatly discourage banks to lend to or invest in the largest number of non-EU entities, as well as require substantial increases in capital requirements associated with securitisations.

The EBF finally wishes to express its agreement with the response submitted to this consultation by the Association for Financial Markets in Europe (AFME), with which it has liaised in the consideration of ESMA’s Consultation Paper.

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<sup>2</sup> Basel Committee on Banking Supervision – “Basel III: A global regulatory framework for more resilient banks and banking systems”, December 2010, p.52.