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In Conversation: Credit rating agencies back in the spotlight?

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CRA regulatory framework

If you cast your mind back to when the first iteration of the CRA Regulation was introduced, in 2009, you will remember the challenges that we were facing at the time. Back then we were dealing with the fallout from the financial crisis. At the same time, we were trying to re-build the framework for financial regulation to make sure that financial stability and investor protection were put on a firmer footing.

One of the areas that was identified as most in need of regulatory oversight was that of credit rating agencies. Indeed, on both sides of the Atlantic it was recognised that introducing supervision and minimum standards for CRAs would be a necessary feature of a re-built financial system. In Europe, spurred on by the aftershocks of the sovereign debt crisis, the CRA Regulation was revised in 2013 with additional requirements in a number of areas such as mechanistic reliance on credit ratings and sovereign ratings.

The CRA Regulation was the first piece of financial legislation that provided for a single European-level supervisor. This is entirely logical given that credit ratings issued by a CRA in one country could be used by investors in any number of Member States.

While there is always room for improvement, , and over the years we have taken the opportunity to flag the areas where the Commission could consider improvements in the CRA Regulation, I believe we can all agree that it was a big step forward for ensuring the quality and reliability of credit ratings in the EU.

Structure of the CRA industry in Europe

In terms of market structure, as of today, there are 27 CRAs in the EU registered with ESMA, located in 13 different Member States. This is a number which has remained relatively stable since the introduction of the CRA Regulation. The market is characterised by a high degree of concentration among a small number of large CRAs. There are also a number of medium sized CRAs who offer the same suite of rating offerings as the large CRAs but don't have the same market share, as well as smaller CRAs who are either specialised in certain industries or certain markets.

Role of ESMA

ESMA, as the regulator of the CRA industry in the EU since 2011, has built up significant supervisory expertise and has shown that supervision at the EU level can work. This has been widely recognised, as additional supervisory mandates, in the area of Trade Repositories (TRs) but also more recently Securitisation Repositories, third country CCPs, Data Reporting Service Providers, and Benchmarks, have been entrusted to ESMA.

To ensure we carry out our mandate in an efficient and effective manner ESMA has adopted a risk-based approach to the supervision of CRAs. This allows us to prioritise our supervisory activities according to the level of risk identified and the outcomes we need to achieve. To address the risks we identify, we have a number of different supervisory tools available to us, ranging from engagement with CRAs to conducting investigations and requesting the implementation of remedial action plans. Where breaches of the regulation are identified, ESMA has the power to adopt enforcement actions. These actions can range from the issuance of public notices to the imposition of fines and the withdrawal of the CRA's registration.

Where needed, ESMA supplements these supervisory activities with the development of public guidance. For example, this year we have published guidance designed to ensure that CRAs have strong internal controls in place to mitigate against conflicts of interest in their rating processes. You may also have seen our Call for Evidence on Access and Use of Credit Ratings. This is a topic that we know is important for investors and the market in general.

For 2021, ESMA's areas of priority will be to identify and address new risks posed by COVID-19, monitor that CRAs are ensuring the independence of their rating processes and assess that their methodologies are robust, systematic and continuous. In addition, ESMA will engage with CRAs to address concerns in the areas of IT and information security controls.

But I appreciate we are not here today to talk about ESMA's supervisory tool kit, interesting as that may be. So, allow me to quickly address what we see as some of the challenges in the area of credit ratings and explain what ESMA is doing to try and meet these challenges.

Challenges ahead

First, **climate change**. The European Green Deal is a key priority. From our vantage point there is still a lot of work ahead of us if we are to ensure that investors have the information points they need to fully integrate ESG factors into their investment decision making processes. In the area of CRAs we have issued Guidelines that aim to increase the transparency of the impact of ESG factors in credit rating actions. Beyond credit ratings, we are aware that CRAs are increasingly active in ESG ratings and the provision of ESG related information. While this is not directly within the scope of our responsibilities, our experience of supervising CRAs and credit ratings has put us in a good position to understand the dynamics of these products and the industry. In line with our expanded mandate under the revised ESMA regulation, and as part of ESMA's wider role as Europe's financial markets regulator, we take an active interest in sustainable finance issues.

Second, **COVID-19**. The recent crisis has had a profound impact on our daily lives and has had a significant economic impact throughout the world. How credit rating agencies take this impact, and the associated government support measures, into account in their analysis is something that has far reaching effects throughout the economy. For our part, we have been actively engaging with CRAs since the start of the crisis to ensure the continuity of their operations were assured, and to understand how they were factoring the economic impact into their analysis. It is also clear that the wave of downgrades that followed the onset of the recent crisis has sparked a renewed debate on the role of, and reliance on, credit ratings in the financial system.

In fact, as highlighted earlier, the issue of **over-reliance** was a key element of the revised CRA regulation package in 2013. While there was some progress made in this area, most noticeably in ensuring that more recent financial regulation avoided mechanistic references to credit ratings, there is still a concern that key pieces of EU financial regulation and private contracts like investment fund documentation contain references to credit ratings that could lead to mechanistic reliance. ESMA is actively participating in this debate through, for example, the ESRB workstreams on procyclicality of credit ratings.