EXPLANATORY MEMORANDUM TO

THE CREDIT RATING AGENCIES REGULATIONS 2010

2010 No. 906

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies ("the EC Regulation") provides for the regulation of credit rating agencies. These Regulations concern matters where the EC Regulation provides for national implementing measures, and they ensure that the EC Regulation is fully effective and enforceable in the United Kingdom.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 The Regulations contain provisions that ensure that the EC Regulation is effective in the United Kingdom. The Regulations designate the Financial Services Authority ("the Authority") as the UK competent authority for the purposes of the EC Regulation, in accordance with Article 22(1) of the EC Regulation. They confer investigatory powers on the Authority in accordance with Article 23 of the EC Regulation, and create national penalties in accordance with Article 36.

4.2 ***Scrutiny Committee history***

Explanatory Memorandum 15661/2008 was sent to both scrutiny committees on 1 December 2008. Following a debate on 27 January 2009 in the European Committee, the committee voted to note the Credit Rating Agency proposal and to endorse the Government's approach, clearing scrutiny for the Commons. The Lords Select Committee on the European Union decided to hold the Explanatory Memorandum under scrutiny in conjunction with its inquiry on EU financial regulation and to request updates on negotiations and a UK Impact Assessment. It was cleared by the House of Lords on 10 March 2009.

5. Territorial Extent and Application

5.1 These Regulations apply to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 The EC Regulation introduces a harmonised approach to the regulation of credit rating activities in the European Union. The Regulation:

- establishes a registration system for credit rating agencies;
- requires registered agencies to comply with various provisions relating to independence, conflicts of interest, employees and analysts, methodologies and models, outsourcing, and disclosure and presentation of information; and
- requires specified financial institutions to use credit ratings for regulatory purposes only if they have been issued or endorsed by a registered credit rating agency, or issued by an overseas agency that has been certified in accordance with the Regulation.

- ***Consolidation***

7.2 The Regulations amend the Capital Requirements Regulations 2006. Other amendments are expected to be made later this year to the 2006 Regulations, and consolidation will be considered at that time.

8. Consultation outcome

The Regulation was published on 17 November 2009 and came into force on 7 December 2009. Member States have to designate competent authorities to exercise functions under the EC Regulation by 7 June 2010. This timetable left insufficient time for a formal 12 week consultation. Instead, the Treasury held an informal four week consultation with relevant stakeholders, including a roundtable meeting to discuss the proposed Regulations. We had responses from the main credit rating agencies and trade associations who were broadly supportive of the draft SI.

9. Guidance

9.1 The Treasury does not propose to produce any guidance in relation to the Regulations. The Committee of European Securities Regulators will produce

guidance in relation to the EC Regulation, and the Authority has the power under the Regulations to issue guidance in relation to the EC Regulation and these Regulations.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible.

10.2 The impact on the public sector is negligible.

10.3 An Impact Assessment is attached to this memorandum.

11. Regulating small business

11.1 There will be no impact on small firms.

12. Monitoring & review

12.1 We expect these Regulations to be amended or revoked in 2011, as it is believed that the EC Regulation will be amended to transfer regulatory responsibility to a new EU body.

13. Contact

Helena Forrest at HM Treasury Tel: 020 7270 5694 or email: Helena.Forrest@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	Impact Assessment of UK Statutory Instrument for Credit Rating Agencies	
Stage: FINAL	Version: FINAL	Date: 19 March 2010

Related Publications: European Commission Impact Assessment
http://ec.europa.eu/internal_market/securities/docs/agencies/impact_assesment_en.pdf

Available to view or download at:

http://www.hm-treasury.gov.uk/consult_ria_index.htm

Contact for enquiries: Helena Forrest Telephone: 0207 270 5694

What is the problem under consideration? Why is government intervention necessary?

The EC Regulation on Credit Rating Agencies (CRAs) applies from 7 December 2009. The EC Regulation is a Community harmonising measure. It is intended to create a common regulatory approach to credit ratings in the EU.

The rationale for the SI is that the EC Regulation provides for certain national implementing measures (eg on penalties), and they ensure that the EC Regulation is fully effective and enforceable in the UK.

What are the policy objectives and the intended effects?

The benefits of designating the FSA as competent authority and drawing upon an established enforcement process, penalties, and appeal process is that it gives legal and regulatory certainty to CRAs who will then be dealing with a well established body and enforcement regime. This will be the least costly option for CRAs who may otherwise have to pay higher fees to establish a new oversight body.

What policy options have been considered? Please justify any preferred option.

Option 1: Designate FSA as competent authority

Option 2: Designate a different competent authority to the FSA or create a new body

Option 3: Do nothing.

The preferred option is to designate the FSA as the competent authority i.e option 1. It is possible that this role may be taken over by the proposed European Securities & Markets Authority (ESMA) on 1 January 2011.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Committee of European Securities Regulators (CESR) will publish an annual report on the application of the EC Regulation by December 2010.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

..... Date: 22.3.10

Summary: Analysis & Evidence

Policy Option: 1	Description: FSA as competent authority

COSTS

ANNUAL COSTS	
One-off (Transition)	**Yrs**
£ 262,500	10
Average Annual Cost (excluding one-off)	
£ 450,000	

Description and scale of **key monetised costs** by 'main affected groups' £262,500 is estimated as the cost to the FSA from June 2010 to January 2011 including all policy and legal staff involved, and their associated overheads such as facilities, premises and general operation. The average annual cost is the estimated cost of running this oversight function annually as may be required by ESMA.

Total Cost (PV) **£ 4,454,972**

Other **key non-monetised costs** by 'main affected groups' The transitional costs of establishing and moving to ESMA oversight are not yet quantifiable, however, they will be the same in all three options.

BENEFITS

ANNUAL BENEFITS	
One-off	**Yrs**
£	
Average Annual Benefit (excluding one-off)	
£	

Description and scale of **key monetised benefits** by 'main affected groups' It has not been possible to monetise the benefits of having transparent, independent and objective CRAs. CRAs play an important role in financial markets and are used to help make informed investment decisions therefore well governed CRAs help increase market confidence in the quality of ratings.

Total Benefit (PV) **£**

Other **key non-monetised benefits** by 'main affected groups' There are very clear but unquantifiable benefits to option 1. Designating the FSA as competent authority is likely to bring synergies with other FSA work and be in practice the best way of meeting EU requirements. The Regulation assumes that the regulator will be a CESR member (and the FSA already is).

Key Assumptions/Sensitivities/Risks : We have used the average annual costs over 10 years.
The supervision of CRAs may be transferred to ESMA in January 2011, although any slippage in time will not affect the choice of options.

Price Base Year 2010	Time Period Years 10	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) **£ - 4,454,972**

What is the geographic coverage of the policy/option?				UK
On what date will the policy be implemented?				7 June 2010
Which organisation(s) will enforce the policy?				FSA
What is the total annual cost of enforcement for these organisations?				£ 450,000
Does enforcement comply with Hampton principles?				Yes
Will implementation go beyond minimum EU requirements?				No
What is the value of the proposed offsetting measure per year?				£ N/A
What is the value of changes in greenhouse gas emissions?				£ N/A
Will the proposal have a significant impact on competition?				No
Annual cost (£-£) per organisation (excluding one-off)	Micro **Nil**	Small **Nil**	Medium **50,000**	Large **150,000**
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Nil Decrease of £ Nil **Net Impact** £ Nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

1. BACKGROUND

Some Credit Rating Agencies in the EU are already subject to the External Credit Assessment Institution (ECAI) regime. Credit ratings may be used for regulatory capital purposes under the Capital Requirements Directive only if the CRA has been recognised under the ECAI regime. ECAIs are recognized as eligible for that purpose by regulatory authorities such as the FSA.

However CRAs were strongly criticised for their role in the market turmoil of 2008, and the Commission under the French Presidency pushed for an EU regulatory response. The Commission consulted on an EU registration regime for CRAs, together with supervisory oversight and enforcement, and a proposed Regulation was published on 12 November 2008.

The Credit Rating Agency Regulation (EC) No 1060/2009 was published on 17 November 2009 and entered into force on 7 December 2009. In summary, it:

- Introduces a harmonised approach to the regulation of credit rating activities in the European Union.
- Establishes a registration system for credit rating agencies.
- Requires registered agencies to comply with various provisions relating to independence, conflicts of interest, employees and analysts, methodologies and models, outsourcing, and disclosure and presentation of information.
- Requires specified financial institutions to use credit ratings for regulatory purposes only if they have been issued or endorsed by a registered CRA, or issued by an overseas agency that has been certified in accordance with the Regulation.

The Regulation is directly applicable, which means it is binding in its entirety and has legal effect in the UK without needing to be transposed. However, the CRA Regulation provides for national implementation, for example to deal with matters such as penalties, enforcement procedures and appeals from registration decisions. This impact assessment, and accompanying evidence base, deals only with the UK Statutory Instrument.

ESMA

It is possible that the European Securities and Markets Authority (ESMA) will supervise CRAs as from January 2011. There may be additional costs for the industry when this happens although these are not quantifiable at this time. It is expected that the FSA will continue to play a part in the oversight of CRAs going forward.

POLICY OPTIONS

We have looked at three options in considering how best to approach the implementation of the national measures.

2. OPTION 1 – Designating the FSA as competent authority

Benefits

Designating the FSA as competent authority clearly brings benefits to the regulation of CRAs. It is difficult to quantify such a benefit, but due consideration should be given to using the existing enforcement regime and the specialist staff and knowledge at the FSA. This translates to good and proper regulation of CRAs and therefore to the maintenance of market confidence, and, ultimately, to investment in the marketplace.

Costs

The FSA estimate that they will spend £262,500 on the regulation of CRAs from June 2010 to January 2011. This cost comprises policy, legal and enforcement resource and is inclusive of both personnel cost and all staff overheads such as facilities, premises, travel and using the existing FSA infrastructure. In addition, the FSA estimate that ongoing annual costs may be around £450,000 as it is expected that CRAs will still have to pay annual fees to the FSA who will continue to have an oversight role after the establishment of ESMA.

Costs incurred by the establishment of ESMA are as yet unquantifiable. However, they will be the same costs incurred independent of which policy option in this evidence base is chosen as the creation of ESMA is independent of our approach to UK implementation.

3. OPTION 2- Designating a different body as competent authority or creating a new competent authority to take on the role of regulating CRAs.

Benefits

The benefits of creating a new body as competent authority would, in theory, be the same as the benefits described in Option 1. CRAs would be subject to proper regulation and market confidence would benefit as a result.

Costs

It is estimated that it would cost at least £1.5m to establish a new body with the necessary supervisory, policy and authorisation experience to conduct the registration of CRAs. This cost is an estimated one, but it is clear in principle that the costs of establishing a new body would be higher than having an existing body take on the role. The cost of this option would therefore be significantly higher than the costs incurred in Option 1 and this would most probably be reflected in the level of fees CRAs would be expected to pay.

The conclusion can be reached that option 2 would present significantly higher costs than option 1. In addition, it is an implicit assumption of the EC Regulation that the competent authority be a member of the Committee of European Securities Regulators (CESR). The FSA is the only UK member of CESR. Option 2 does not therefore appear to be a viable option.

OPTION 3 – Do nothing

Under this option, the UK would not implement the national measures to deal with matters such as designating a competent authority, penalties, enforcement procedures, and appeals. In principle, not implementing regime change is frequently considered as part of an evidence base so that the costs and benefits of each option can be compared.

Benefits

Costs incurred by the industry and indeed the FSA are likely to be less than under options 1 and 2. It is debatable as to whether they would actually reduce to zero due to the direct applicability of the European regulation.

Benefits to industry and market confidence would be substantially reduced from option 1 and 2, as there would not be a system of proper regulation of CRAs.

Costs

The UK would run the risk of infraction proceedings if national measures are not implemented. Other member states are implementing the regulation and so the UK would possibly be put at a disadvantage competitively.

Option 3 is not therefore a viable option.

4. COMPETITION ASSESSMENT

The UK SI will have no effect on competition

5. IMPACT ON SMALL FIRMS

There will be no impact on small firms

6. EQUALITY ASSESSMENTS

The legislation should have no impact on race, disability, gender equality.

7. HUMAN RIGHTS

The legislation will have no impact on human rights

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

European Impact Assessment

http://ec.europa.eu/internal_market/securities/docs/agencies/impact_assesment_en.pdf

Draft SI