INVESTORS' AND MARKET PARTICIANTS' OVER-RELIANCE ON EXTERNAL CREDIT RATINGS: TO WHAT EXTENT DOES EU LAW CARRY THIS RISK?

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Abstract

The risk of over-reliance on external credit ratings by investors and market participants was highlighted in the context of the recent post-crisis credit rating agencies' reforms. This problem stems from the inclusion of credit ratings into legislation. Accordingly, regulators agreed upon an approach based on a review of the credit rating references found in legislation and regulatory frameworks. At the EU level, this approach has been set out in the European regulation of CRAs. This paper aims to investigate the hardwiring of credit ratings into the EU's financial legislation in order to assess the extent to which this poses a significant risk of over-reliance. The present analysis relies on the outcomes of the recent joint report that the European supervisory authorities has issued with regard to the risk of over-reliance on credit ratings in their own recommendations, guidelines and draft technical standards. These can form the platform for a wider discussion on the degree of importance that European regulators gave to credit ratings in legislation and regulatory frameworks.

1. Introduction

Credit ratings are important tools for evaluating the creditworthiness of borrowers such as corporations, sovereign governments and municipalities. Their viability to reduce information asymmetries and transaction costs between issuers of debt instruments and investors has made them widely used by the private and public sectors. As a result, the credit rating agencies (CRAs) have been given a prominent position in the financial markets.[1] At the EU level, before the 2007-2009 financial crisis, three European directives referring to CRAs, namely the Market Abuse Directive (MAD), the Capital Requirement Directive (CRD) and the Market in Financial Instrument Directive (MIFID), along with the set of best practices elaborated by the International Organisation of Securities Commissioners (IOSCO Code), were considered a robust enough framework to deal with the rating sector.[2]

However, after the financial crisis the European stance towards this self-regulation model went into reverse. The crisis triggered worldwide government bail-outs and the granting of credit guarantees to large banks and financial institutions, which were on the brink of collapse in the wake

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[1] Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L. W., 619 (1999).

[2] Commission, *Communication from the Commission on Credit Rating Agencies*, 2006 OJ C59/2.

of the Lehman Brothers bankruptcy.[3] In this context, the European regulators started to rethink their previous regulatory approaches and the rating sector was earmarked to be the first to receive such attention because of the role played by the CRAs.[4] The abovementioned directives were no longer considered a sufficient regulatory framework for CRAs and the IOSCO Code was regarded as a 'toothless wonder' to discipline CRAs.[5] The pace of reform was very fast and resulted in three regulations issued between 2009 and 2013. The last piece of legislation, Regulation No 462/2013 (CRA Regulation III), improved upon the earlier legislation by revisiting the rules on conflict of interest, structured finance and sovereign ratings and by setting out a civil liability regime for CRAs.[6]

Within this body of rules, three provisions dealing with the risk of 'sole or mechanistic reliance' on credit ratings by investors and market participants appear to be the odd ones out. Indeed, these provisions are not concerned with the structure and operation of the rating industry but with the investors' and market participants' approach to credit ratings. Significantly, they address the possibility that references to credit ratings in legislation and regulatory frameworks can be interpreted as 'official seals of approval' of creditworthiness imprinted by the regulators. Consequently, the investors and market participants would neglect their own due diligence and credit risk assessment by using the credit ratings as exclusive benchmarks for assessing the credit risk. In a word, these rules refer to the phenomenon of over-reliance on external credit ratings that the post-crisis regulatory debate on the CRAs exposed among other issues. In light of this risk, under Article 5(b) of CRA Regulation III the European Supervisory Authorities (ESAs) and the European systemic Risk Board (ESRB) are required to complete a review of the credit rating references in their recommendations, guidelines and draft technical standards to identify and remove those references to credit ratings which can trigger sole or mechanistic reliance on credit ratings. At the same time, this review and removal approach is intertwined with Article 5(a) which encourages investors and market participants to perform a more independent credit risk analysis and not to rely solely or mechanistically on credit ratings. In the first half of 2014, the ESAs issued the results of their review work. These stimulate numerous reflections in relation to the same review work that the Commission is mandated to complete by 2020 as to the credit rating references in EU law.[7]

This paper analyses the extent to which credit rating references in EU law carry the risk of inducing mechanistic reliance by investors and market participants. By critically reviewing the work of the ESAs, and discussing the future Commission's review of the EU's financial legislation, this paper will seek to answer the question of whether the references to credit ratings in EU law carry an effective risk of over-reliance. Such an analysis requires, firstly, a clarification of the phenomenon of over-reliance on external credit ratings; secondly, an illustration of the European rules which have been laid down to tackle this phenomenon; and thirdly, scrutiny of the current status of their implementation in accordance with the timeframe set out in CRA Regulation III. Specifically, the analysis is not centred on the feasibility of the European approaches to eliminate over-reliance, but

[3] Frederic S. Mishkin, *Over the Cliff: From the Subprime to the Global Financial Crisis,* 16609 NBER WP (2010).
[4] The agencies were accused of 1) inflating the ratings assigned to some structured products such as residential mortgage backed securities (RMBSs) and collateralized debt obligations (CDOs) because of conflict of interest with the issuers; 2) having inadequate rating methodologies and models for assessing the risk inherent to such complex products; and 3) being slow in downgrading them promptly. *See* John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 123 (2009).
[5] Charles McCreevy, *Regulating in a Global Market,* SP/08/334 (2008) available at <http://europa.eu/rapid/press-release_SPEECH-08-334_de.htm?locale=de>.
[6] Regulation 462/2013, 2013 OJ (L146/1). *See* also Gudula Deipenbrock, *Trying or Failing Better Next Time?-The European Legal Framework for Credit Rating Agencies After its Second Reform*, 25 EUR. BUS. L. REV 2, 207 (2014).
[7] *See*, Article 5(c) of Regulation 462/2013.

on investigating the degree of importance that the European regulators gave to credit ratings in the EU's financial legislation.

Accordingly, the remainder of this paper is structured as follows. The second section introduces the phenomenon of over-reliance and explains it in relation to the two different contexts in which it may arise, namely: the hardwiring of credit ratings into legislation and regulatory frameworks and the structured finance sector. The third section will provide an exegesis of the EU rules against over-reliance by regarding them as the full endorsement of the soft-law principles elaborated, at the international level, by the Financial Stability Board (FSB). The third section will assess the degree of implementation of the rules incorporated into CRA Regulation III by critically analysing the outcomes of the ESAs' review. The fourth section will discuss the work that the Commission will complete by 2020. In this respect, an analysis of the role of credit ratings in the main pieces of EU's financial legislation will cast light on the potential risk of over-reliance. This will permit us to draw a conclusion on the use that the European regulators have made of the credit ratings in their legislation and whether this may increase the risk of over-reliance.

2. Defining Over-reliance on External Credit Ratings

Following the dramatic events of the 2007-2009 financial crisis, regulators and policymakers tried to identify opportune regulatory measures to restore financial stability worldwide. In its 2008 report on enhancing market and institutional resilience, the FSB, among other things, warned investors and market participants to avoid over-relying on external credit ratings.[8] Specifically, the FSB underlined that some institutional investors depended heavily on credit ratings in their investment guidelines and choices. This had the effect of giving credit ratings the role of exclusive benchmarks for the assessment of credit risk to the detriment of a complementary, and independent, credit risk assessment and due diligence.[9] The FSB identified the source of this specific problem in the embedding of credit ratings in regulatory and legislative frameworks at the international and national levels. In other words, the FSB warned against the risk that investors and market participants might perceive the legislative requirements to invest in highly rated products as guarantees of creditworthiness. As a result, they would not perform their own due diligence and credit risk assessment in addition to the credit quality analysis provided by the CRAs. Over-reliance was not, however, exclusively traced back to the hardwiring of credit ratings into legislation and the regulatory frameworks. The FSB report stated that over-reliance on credit ratings was also particularly acute in the structured finance sector during the years leading up to the recent financial crisis.[10] With regard to the structured finance sector, it is commonly acknowledged that investors misunderstood the specificities and limits of the structured finance ratings. In essence, they wrongly assumed that the ratings assigned to structured products such as Residential Mortgage Backed Securities (RMBSs) and Collateralised Debt Obligations (CDOs) covered the market risk and liquidity risk in addition to the credit risk.[11] There are clearly two contexts in which over-reliance may occur. Significantly, the FSB introduced the problem of over-reliance on external credit ratings without providing a specific definition of it. The FSB only indicated who may over-rely, that is, investors and market participants, and the contexts in which the phenomenon may arise. There is therefore a definitional gap which needs to be closed. Indeed, over-reliance is addressed through different regulatory approaches according on whether it stems from the rating-based regulation or the structured finance sector. This confirms that there are

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[8] FSB, *Report of the FSF on Enhancing Market and Institutional Resilience* (2008) available at <http://www.fsforum.org/publications/r_0804.pdf>.

[9] *Id*.

[10] *Id*, at 36.

[11] European Securities and Markets Authority (ESMA), *The Role of Credit Rating Agencies in Structured Finance-Consultation Paper* (2008).

two types of over-reliance. Thus, it is worth providing a clearer understanding of them through the elaboration of a specific definition.

As to the structured finance sector, at the EU level the Committee of European Securities Regulators (CESR) summarised the investors' risk analysis approach to the sophisticated structured finance products as follows: 'it's [the structured product] AAA rated so it's safe, valuable and liquid'.[12] Undoubtedly, the investment grade ratings assigned by the CRAs to such products were interpreted as a guarantee of creditworthiness. As a result, investors did not perform any independent, complementary analysis. This raises the question of how this assumption could take place. According to the IOSCO, this happened 'either because they were lax or ignorant'.[13]

These two adjectives, 'lax or ignorant', are the basis for drawing a comparison between the phenomenon of over-reliance in the context of the rating-based regulation and in the context of the structured finance sector. Interpreting them literally, while the former refers to a lack of care, attention or control, the latter denotes a lack of knowledge, understanding or information about something. Placing these meanings in the context of over-reliance, it can be argued that laxity pertains more to the over-reliance arising from the rating-based regulation, whereas ignorance characterises the over-reliance present in the structured finance sector. In the rating-based regulation context, over-reliance is ascribed to the investor's laxness in respect of undertaking her own due diligence and credit risk assessment. This is due to a misperception of the role assigned by regulators to credit ratings in legislation. Generally speaking, the 'seal of approval' interpretation does not necessarily imply ignorance of the characteristics and limits of the products or, above all, of the credit ratings. Market participants who invest in highly rated products under legislative requirements may be aware of the limits of credit ratings; especially if they invest in those debt instruments whose risk characteristics may be gauged more easily than a complex, highly sophisticated, structured product. From an over-reliance perspective, they would not say, 'it's AAA rated so it's safe, valuable and liquid'. Instead, they might say, 'it's AAA rated and this is required by regulators; hence, I am safe and sound and nothing else is needed'. This reasoning does not necessarily overestimate the limits of credit ratings; but it leads them to neglect their own due diligence and fail to undertake a credit risk assessment which should be done in addition to, or as a complement to, the risk analysis provided by the CRAs. In essence, they are not incentivised to undertake their own credit risk assessment, even though they may have the capacity and possibility of doing so.

By contrast, in the structured finance sector, if they do not have a clear understanding of the products and of the specificities of their credit ratings, they will not have the capacity or the possibility of conducting their own due diligence and credit risk assessment. A lack of understanding of the products that an investor would like to buy, means not knowing its features and risk characteristics; in turn, not knowing the financial product to be purchased implies ignorance. This ignorance may ultimately lead to a mischaracterisation of the limits of the credit ratings as occurred before the outbreak of the recent financial crisis. Clearly, in the structured finance sector, these problems stem from the lack of awareness of the necessary information whether on the characteristics of the structured products or on the specificities of the credit ratings assigned to them. Importantly, increasing the level of the investors' understanding of the characteristics of the structured finance ratings through more disclosure on the part of the CRAs is part of the current regulatory strategies to reduce over-reliance in the structured finance sector in the EU[14] and the US.[15] This goes hand-in-hand with more disclosure on the characteristics of the structured finance products by the issuers.

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[12] ESMA, *Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance*, CESR/08-277, 206 (2008).
[13] IOSCO, *The Role of Credit Rating Agencies in Structured Finance Markets-Final Report* (2008).
[14] Fabian Amtenbrink & Jacob De Haan, *Taming the Beast? New European Regulation on Credit Rating Agencies* (2012) 10 J. COMP. GOV. & EUR. POL'Y 4, 450 (2012).
[15] Steven Mc Namara, *Informational Failures and Structured Finance and Dodd Frank's Improvement to the Regulation of Credit Rating Agencies* 17 FORDHAM J. CORP. & FIN. L. 3, 667 (2012).

Indeed, the higher the level of sophistication of the structured finance products, the greater the risk that the purchasers will not have a clear understanding of them. This, in turn, will increase their ignorance and raise the risk that they may perceive a triple A as a guarantee of good investments. In this context, their over-reliance on credit ratings seems to be the natural result of their lack of necessary information. Therefore, a lack of their own due diligence and credit risk assessment is not a matter of laxness, but a matter of impossibility because of a lack of necessary information. In light of this discussion, a line of demarcation can be finally drawn between the two types of over-reliance: the first stems from the use of credit ratings by the public sector; and the second relates to the structured finance sector. In the first area, over-reliance is the investors' and market participants' misunderstanding of the role of credit ratings in financial regulation which finally leads them to be negligent in conducting their own credit risk assessment. In the second area, over-reliance originates from the lack of necessary information on the products and their ratings. This makes investors unable to undertake their own due diligence and credit risk assessment and may lead them to rely exclusively on credit ratings for the assessment of credit risk. In this context credit ratings are not the 'seal of approval' of creditworthiness by regulators, but the 'seal of creditworthiness' by CRAs.

Having distinguished two areas which carry the risk of over-reliance, it is possible to summarise the result of the present analysis into a definition of over-reliance and, thus, close the definitional gap in the FSB report. Over-reliance on external credit ratings is a behavioural phenomenon which may originate from two contexts, that is, the rating-based regulation and the structured finance context. Within the hardwiring of credit ratings in financial legislation, over-reliance is the misperception of the roles of credit ratings in legislation and regulatory frameworks. This misperception results in the investors' and market participants' laxness in conducting their own due diligence and credit risk assessment. In the structured finance sector, over-reliance is the mischaracterisation of the nature and limits of the credit ratings. This depends on the impossibility of conducting one's own due diligence and credit risk assessment due to a lack of necessary information on the products and their ratings.

3. The European Approach Against Over-reliance on External Credit Ratings

3.1. *International sources: the FSB two-pronged approach*

Within the context of over-reliance deriving from the rating-based regulation, the FSB encouraged authorities to check the role they assigned to credit ratings in their regulations and supervisory rules. The FSB underlined that credit rating references should not facilitate undue reliance on credit ratings and should be consistent with the aim of having investors perform an autonomous judgement of risks and proper due diligence.[16] The authorities' task was hence concerned with reviewing whether investment grade rating requirements in regulations and supervisory policies could be perceived by investors and market participants as an official recognition of creditworthiness; and, for this reason, act as a disincentive to perform additional due diligence and credit risk assessments.[17] To this end, in 2010 the FSB issued a set of principles to reduce reliance on credit ratings.[18] These principles are the source on which the current European rules against over-reliance are based.

Before detailing the European approaches, some considerations are necessary to clarify how over-reliance is addressed in the FSB principles. The set of principles is, in fact, entitled 'Principles for Reducing Reliance on Credit Ratings' and not 'Principles for Reducing Over-reliance on Credit Ratings'. In light of this, it must be assessed whether there is an explicit or implicit reference to over-

[16] *See* FSB, *supra* note 8.
[17] Id, at 38: the FSB underlined how credit ratings are embedded into laws and regulatory frameworks at the international and national levels and remarked how such official recognition in regulations or supervisory policies may have played a role in encouraging investors' over-reliance on ratings.
[18] FSB, *Principles for Reducing Reliance on Credit Ratings* (2010).

reliance so that the set of principles can be regarded as fixing the approach to tackle over-reliance on external credit ratings. In this respect, it is desirable to analyse the purpose and contents of the FSB recommendations. To start with, in the explanatory notes, the FSB refers to the need to reduce the cliff-edge effects associated with rating downgrades and the potential for herd-behaviour. Whereas the first refers to a dramatic sale of debt instruments whose credit rating has been downgraded below a certain threshold, the second refers to the possibility that other investors may behave in the same fashion without rationality.[19]

Both cliff-edge effects and herd behaviour are exacerbated by 'mechanistic reliance on credit ratings' which, in turn, is facilitated by the hardwiring of credit ratings in legislation and regulatory frameworks. Clearly, the FSB replaced the word over-reliance with a specific one: 'mechanistic reliance'. However, no definition was provided by the FSB. Nonetheless, by reflecting upon the context that the FSB set out to introduce its principles, it can be noted that over-reliance and mechanistic reliance may be used as synonyms. A practical example will help clarify this assertion. For instance, where asset managers are required by law to hold in their portfolio debt instruments rated investment grade, in the event of downgrades they may start selling them. In parallel, others may behave in the same manner. Significantly, this is an example of reactions which are mechanistically triggered by the rating downgrades and facilitated by a legislative requirement to invest in highly rated debt instruments. These phenomena arise when credit ratings are taken at face value with no complementary, independent analysis; put simply, when investors overly rely on credit ratings to the extent that they become the primary and exclusive benchmarks to assess creditworthiness. Consequently, mechanistic reliance and over-reliance can be used to define the same issue: a problem of investors' best practice which may originate from the use of credit ratings in legislation. To cease or reduce this potential, it is necessary to intervene first at the source of the risk, namely, through the rating-based regulation. This implies stopping regulators from including credit ratings in financial regulations. Indeed, this strategy is the rationale behind the first of the principles promoted by the FSB. According to FSB Principle I, standard setters, regulators and policymakers are required to review references to credit ratings in their standards and regulations and, where appropriate, replace them with alternative standards of creditworthiness.[20] FSB Principle I is regarded as the first level of the approach elaborated by the FSB. Basically, the overall approach is a strategy to be put into practice through two intertwined levels. The first level is incorporated in FSB Principle I and the second in FSB Principle II.[21]

The second principle requires investors and market participants to undertake their own credit risk assessment and due diligence and not to rely solely or mechanistically on credit ratings.[22] The connection between the two levels of the FSB approach is apparent in the fact that the second level can be implemented consequently to the development of the first level: once credit rating references are removed and replaced by alternative standards of creditworthiness, investors and market participants will be more independent from the credit ratings and will prioritise their own due diligence and credit assessment.[23] Based on this, it can be claimed that FSB Principle II is the provision targeting over-reliance by the investors and market participants. In other words, over-reliance stems from the hardwiring, but it is finally materialised through the conduct of investors and market participants. Therefore, FSB Principle II is needed to encourage an independent more autonomous credit risk analysis in addition to the first principle which requires regulators and

[19] *See* Avinash Persaud, *Sending the Herd Off the Cliff Edge: The Disturbing Interaction Between Herding and Market Risk Sensitive Risk Management Practices* BIS Paper 2 (2000) available at <http://www.bis.org/publ/bppdf/bispap02l.pdf>.

[20] *See* FSB Principle I, in the explanatory table it is stressed that it is particularly pressing removing credit rating references where they lead to mechanistic responses by market participants.

[21] FSB, *Thematic Review on FSB Principles for Reducing Reliance on Credit Rating Agency Ratings: Interim Report* (2013).

[22] *See* FSB Principle II.

[23] FSB, *supra* note 8.

standard setters to reduce the amount of credit rating references in their legislation and regulatory frameworks. The two-pronged approach involves all the principal actors and users of external credit ratings in the financial markets: from large, sophisticated, financial institutions, including central banks, to smaller, less sophisticated financial firms as well as investment managers who have mandates to invest in highly rated financial products. Importantly, the FSB Principles represent an approach to eliminate the investors' and market participants' over-reliance through the reduction of the regulators' reliance on credit ratings. This assertion can be finally confirmed by examining the contents of the over-reliance rules incorporated in the European legislation on CRAs.

3.2.Over-reliance under the European regulation of CRAs

By looking at the three pieces of European legislation on CRAs it is apparent that the European regulators took the problem of over-reliance into consideration as initially encouraged by the FSB. Regulation No 1060/2009 (CRA Regulation I) did not include any specific provision on over-reliance, only a reference under Recital No 10 in which it is stated that investors should not excessively rely on credit ratings and should instead perform their own credit risk assessment and due diligence.[24] However, CRA Regulation I was the stepping-stone towards the current broader regulation encompassing all the issues that had initially been left out. These are: sovereign rating methodologies, CRAs' civil liability and disclosure requirements with regard to the rating of structured finance products.[25] Over-reliance on external credit ratings was included as well.[26] It can be observed that the consultations and preparatory works leading to the drafting of CRA Regulation III reflected a full endorsement of the Principles that the FSB had issued. In particular, from the impact assessment study of the third piece of the CRA legislation, it can be seen that the aim was to pursue a strategy conforming to the set of principles.[27] Finally, the transposition of the FSB two-pronged approach can be found in Articles 5(a), 5(b) and 5(c) of CRA Regulation III. Both Articles 5(b) and 5(c) implement FSB Principle I. By analysing them separately, Article 5(b) of CRA Regulation III requires the ESAs, namely the European Banking Authority (EBA), the European Securities Market Authority (ESMA) and the European Insurance and Occupational Pension Authority (EIOPA) not to refer to credit ratings in their guidelines, recommendations and draft technical standards where these references carry the potential to trigger sole or mechanistic reliance on credit ratings by authorities and market participants. Furthermore, the rule requests that the concerned authorities review and remove, where appropriate, all such references to credit ratings in their existing guidelines, recommendations and draft technical standards.[28] Unquestionably, this rule mirrors the contents of FSB Principle I. Similarly, Article 5(c) tasks the Commission with monitoring whether credit rating references in EU law can trigger a 'sole or mechanistic reliance' on credit ratings by financial authorities, investors and market participants. As the Article specifies further, the purpose is to delete such references by

[24] *See* Recital No 10 of Regulation 1060/2009, 2009 OJ (L 302): 'The users of credit ratings should not rely blindly on credit ratings but should take utmost care to perform own analysis and conduct appropriate due diligence at all times regarding their reliance on such credit ratings'.
[25] Gudula Deipenbrock, *supra* note 6.
[26] Recital No 9 of CRA Regulation III: 'Over-reliance on credit ratings should be reduced and all the automatic effects deriving from credit ratings should be gradually eliminated. Credit Institutions and investment firms should be encouraged to put in place internal procedures in order to make their own credit risk assessment and should encourage investors to perform a due diligence exercise'.
[27] Commission, *Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on credit rating agencies* SEC(2010)COM, 678 (2010).
[28] Art 5(b) of CRA Regulation III; *see* also Recital No 3 of CRA Regulation III in which the endorsement of the FSB Principles and Recital No 5 in which central banks are encouraged, in line with the FSB Principles, to reach their own credit judgment on the financial instruments they may accept both as collateral and as outright purchases is remarked.

2020 once appropriate alternatives have been found.[29] This rule is entitled 'Over-reliance in the EU Law'. On the one hand, it mirrors the contents of FSB Principle I as to the review and removal process that the Commission is required to complete by 2020. On the other hand, it is entitled 'over-reliance' and the words 'sole and mechanistic reliance' appear in its text. This confirms the initial assertion that over-reliance and mechanistic reliance can be used as interchangeable terms. They both apply to the investors' and market participants' practice of giving exclusivity to the credit ratings as tools for assessing the creditworthiness of debt instruments. This jeopardises their capability to perform an independent credit risk analysis and reduces the possibility of considering other factors as alternatives to the credit ratings for measuring creditworthiness. Finally, the transposition of FSB Principle II can be identified in Article 5(a). This rule is entitled 'Over-reliance on Credit Ratings by Financial Institutions' and requires financial institutions to make their own credit quality assessment and not solely and mechanistically rely on credit ratings.[30] Article 5(a) of CRA Regulation III gives credence to the assertion that FSB Principle II refers to and has to be regarded as the approach set out at the international level to tackle the problem of over-reliance as it applies to the investors' and market participants' approach to credit ratings.

The full integration of the FSB approach into post-crisis EU legislation can also be seen out of the context of the specific legislation of CRAs. For instance, Directive 2013/14/EU, issued in May 2013, has amended the European directives on the activities and supervision of institutions for occupational retirement provision (IORP Directive), on the regulation of undertakings for collective investment in transferable securities (UCITS Directive) and on alternative investment fund managers (AIFM Directive).[31] Amendments were applied with respect to over-reliance on credit ratings and, again, they reflect the FSB Principles to the extent that in order to improve the quality of investments made by IORPs, UCITS and AIFMs, Directive 2013/14/EU states that it is not desirable to rely 'solely and mechanistically' on credit ratings or use them as the only parameter when assessing the risk involved in the investment made by IORPs, UCITS and AIFMs.[32] All things considered, it can now be said that the regulatory debate on over-reliance was prompted by the FSB and developed into a set of principles that the FSB jurisdictions are required to translate into their own legislation and implement within a reasonable timeframe. These principles fix the approach against over-reliance.

To complete the analysis, it must be underlined that the FSB approach does not pursue a total elimination of the credit ratings from legislation, rather only the elimination of those credit rating references which can induce over-reliance.[33] For this reason, regulatory reliance on credit ratings is not to be eliminated but reduced to eliminate the problem of over-reliance by investors and market participants.

4. Credit Rating References in Guidelines, Recommendations and Draft Technical Standards

4.1.The ESAs review under Article 5(b) of CRA Regulation III

The European regulators have made a full endorsement of the FSB approach by setting out specific rules in CRA Regulation III. As mentioned above, Article 5(b) of CRA Regulation III mandates that the ESAs conduct a stocktaking review of the credit rating references in their guidelines, recommendations and draft technical standards. The ESAs completed their review and issued their

[29] Art 5(c) of CRA Regulation III, *see* also Recital No 6 of CRA Regulation III which anticipates the contents of Art 5(c).
[30] Art 5(a) of CRA Regulation III.
[31] Directive 2013/14/EU, (2013) OJ (L145/1).
[32] *See* Recital No 2 of Directive 2013/14/EU.
[33] FSB Principle I: 'it is particularly pressing to remove or replace such references where they lead to mechanistic responses by market participants'.

result in the first half of 2014. Accordingly, a critical assessment can be made in relation to the purpose of the present investigation, that is, whether the use of the credit ratings by the European regulators carry the risk of over-reliance as defined above.[34] In their stocktaking review, the ESAs underlined that the Commission gave them the mandate to identify references which can induce mechanistic reliance on external credit ratings without providing any definition of mechanistic reliance.[35] Clearly, the ESAs' review could not take place without a preliminary clarification of what mechanistic reliance is. Consequently, their first task was to set out a definition of mechanistic reliance to facilitate the identification of the credit rating references which can carry such a risk. According to the final draft of the consultation paper on the enactment of Article 5(b) of CRA Regulation III issued in 2014, the definition of mechanistic reliance reads as follows: 'it is considered that there is sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion'. The ESAs clarified that such a definition can be traced back to the preparatory works which finally led the Commission, the European Parliament and the Council of Europe (the European Institutions) to finalise the last piece of European legislation on CRAs.[36] In practice, this definition is the result of the understanding reached by the European Institutions during the negotiation of CRA Regulation III. However, such an understanding has never been translated into a specific definition. The definition of mechanistic reliance provided by the ESAs can be considered as a summary of the broader definition of over-reliance which was provided in the second section of this paper by contrasting two sectors at risk of over-reliance. In their definition the ESAs emphasise the negligent conduct of investors and market participants in performing their own due diligence and credit assessment when they give prominence to credit ratings as credit risk assessment tools. Such conduct can exacerbate cliff-edge effects and parallel behaviours on the part of other investors and market participants. While the 'action' indicated in the definition refers indeed to these phenomena, the 'omission' is to be referred to as the lack of any credit risk assessment complementary to the analysis provided by the CRAs. This gives the credit ratings the exclusivity and primacy as a means for assessing credit risk. Even though there is no explicit reference to the misperception of credit ratings as an official seal of approval of creditworthiness, the ESAs' definition is, in any case, in relation to the negligent conduct of investors and market participants which connotes the type of over-reliance stemming from the hardwiring of credit ratings in legislation and regulatory frameworks. Finally, the ESAs underlined that regulations based on external credit ratings are the source of the problems at hand.[37]

Their definition constitutes the standard upon which the three authorities could perform and complete their review. In practice, through their definition of mechanistic reliance their work could have easily selected specific credit rating references in their recommendations, guidelines, and draft technical standards. This, in turn, could have guaranteed compliance with the letter of Article 5(b) and with the rationale behind FSB Principle I. Accordingly, the following discussion is based on the results of their review.

4.2.The EBA's review

The EBA's assessment referred to the guidelines on the recognition of External Credit Assessment Institutions (ECAI) that the authority issued in 2010.[38] Within these guidelines, those concerning the

[34] EBA, EIOPA and ESMA (ESAs), *Final Report on Mechanistic References to Credit Ratings in the ESA's Guidelines and Recommendations*, JC 2014-004 (2014).
[35] ESAs, *Joint Consultation Paper on Mechanistic References to Credit Ratings in the ESA's Guidelines and Recommendations*, JC-CP-2013-02 (2013).
[36] ESAs, *supra* note 34.
[37] *Id*.
[38] The guidelines were intended to provide consistency across jurisdictions on the External Credit Assessment Institutions (ECAI) recognition for the determination of capital requirements under the SA and

mapping to external ratings in the standardised approach (SA) and the mapping for securitisation exposures came under the EBA spotlight with regard to the risk of mechanistic reliance. To have a better understanding of this, some preliminary explanations are in order.

Under the Basel II capital adequacy framework, banking institutions are allowed to use the SA and, thus, rely on external credit ratings to calculate the capital requirements for credit risk. At the EU level, the Basel II framework and its SA were subsequently transposed into the CRD legislation comprising Directives 2006/48/EC and 2006/49/EC. The SA was retained in the new Basel III framework as well as in the recent CRD IV legislation comprising Regulation EU No 575/2013 (CRR) and Directive 2013/36/EU (CRD).[39] Taking position from the first source, that is, the Basel II framework, Annex 2 identifies the mapping process as the correspondence between the credit risk assessment to risk weights determined by an eligible ECAI under the SA, and the credit quality steps (CQS). What this means is that once a rating agency is eligible to be recognised as an ECAI its credit assessments are mapped by supervisors to the CQS defined by the Basel II framework. As is known, the framework also determines the risk weight (amount of capital) to be applied to each exposure. The banking supervisory authorities are responsible for the mapping process and, as specified in Annex 2, they have to consider a variety of qualitative and quantitative factors to differentiate between the relative degrees of risk expressed by each assessment, including, inter alia, the pool of issuers that each agency covers, the range of ratings that an agency assigns, each rating's meaning and each agency's definition of default.[40] In relation to Annex 2 of the Basel II framework, Article 82 of CRD III specifies that the competent authorities shall determine, in an objective and consistent manner, with which of the CQS set out in Directive 2006/48/EC the credit assessment provided by ECAI are to be mapped.[41]

The 2010 EBA guidelines were issued in the context of such rules and principles with the view to setting out a common approach to mapping and hence ensuring consistency across the EU to reduce the risk of regulatory arbitrage.[42] With regard to the use of external credit ratings and their mapping under the SA, the EBA underlined that CQS may change in the event of rating downgrades. In turn, this will determine an increase in the capital requirements. The EBA identifies this situation as an example of mechanistic reliance because institutions cannot rely on risk assessment tools alternative to credit ratings.[43] Similar conclusions were drawn in relation to the mapping process for securitisation exposures. Therefore, the EBA was able to identify what, in its view, can be the source of mechanistic reliance on external credit ratings and should be accordingly repealed under Article 5(b) of CRA Regulation III.[44]

However, what causes debate is not the identified guidelines but how the EBA decided to react. In other words, the EBA's justification for why it feels it is not opportune to apply any amendment. To begin with, there are technical reasons. These can be traced back to the forthcoming implementing technical standards (ITS) specifying the mapping of ECAIs to CQS which the EBA have the task of drafting under the CRR. The ITS will automatically amend the guidelines. Consequently, any amendment before the issuance of the ITS would not make sense.[45] Secondly, the

in relation to the securitisation ratings-based approach, *see* EBA, *Revised Guidelines on the Recognition of External Credit Assessment Institutions* (2010).

[39] 'Regulation 575/2013, 2013 OJ (L176/1); *see* also Directive 2013/36/EU, 2013 OJ (L176/338).

[40] BCBS, *International Convergence of Capital Measurement and Capital Standards, A revised Framework* Annex 2 Standardized Approach-Implementing the Mapping Process (2006); *see* also BCBS, *The Standardised Approach to Credit Risk*, Supporting Document to the New Basel Capital Accord (2001).

[41] *See* Directive 2010/76/EC, 2010 OJ (L329/3).

[42] EBA, *supra* note 38.

[43] ESAs, *supra* note 34 .

[44] *Id*.

[45] ESAs, *Consultation Paper on Draft Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirement Regulation-CRR)*, JC/CP/2014/01 (2014).

EBA questions its authority to apply the amendments requested by the letter of Article 5(b). Interestingly, the EBA argues that the risk of over-reliance stems primarily from the SA rather than exclusively from its guidelines. Next, this risk may continue through the implementing legislation, namely the CRD III and IV. In this context, it is the task of the Basel Committee Task Force on the SA to find appropriate alternatives for the mapping to external credit ratings in the approach and for securitisation exposure. This would allow a change in the implementing legislation and possibly new guidelines in accordance with it.[46]

Furthermore, the EBA underlines that any amendments to its guidelines cannot have any effect on the implementing legislation, namely the CRR. In practice, guidelines and recommendations issued by the ESAs cannot repeal any legislation and, thus, the EBA feels that it is not opportune to take any steps. These are the legal reasons which prevent the EBA from fully complying with Article 5(b). Based on this, it can be observed that, at least for the EBA, the mandate set out in Article 5(b) has remained on paper or has been left unrealised. The message from the EBA appears to be clear: the forthcoming ITS will take into consideration the risk of over-reliance. However, what is indicated as essential is the elaboration of alternatives to external credit ratings. In this respect, the problem may be not only the objective difficulty in finding accepted alternatives but also the willingness on the part of the Basel arena to discuss the possibility of finding alternatives as substitutes to the credit ratings. Significantly, the EBA's room for manoeuvre seems to be very limited, even though it identified some references to credit ratings which may induce mechanist reliance. Its justifications with regard to the opportunity of not applying any changes to its guidelines is logical in relation to the fact that any change should come first from the source upon which the European legislation on capital requirements is based, that is, the Basel framework. This would permit the EBA to issue new guidelines or ITS for the finalisation of new bodies of rules that the EU competent institutions would elaborate on in accordance with the Basel soft-law rules.

4.3.The ESMA's review

The ESMA performed its review in relation to the 2010 CESR's guidelines providing a definition of money market funds.[47] When they were issued, the guidelines were aimed at ensuring investors' protection through a harmonised definition of money market funds. The guidelines drew a line between short-term money market funds (STMMFs) and money market funds (MMFs).[48] With regard to over-reliance, Boxes 2 and 3 of the ESMA's guidelines, relating respectively to STMMFs and MMFs, came under scrutiny.

According to the ESMA, references to external credit ratings in Boxes 2 and 3 can create undue reliance on the part of asset managers. In point 3 of box 2 it is stated that STMMFs have to invest in debt instruments which are of a high quality. The determination of 'high quality' is the task of the management company and, to this end, the guidelines specify that a wide range of factors can be taken into account, among them: (a) the credit quality of the instrument; (b) the nature of the asset class represented by the instrument; (c) the operational and counterparty risk when it is a structured finance transaction; and (d) the liquidity profile.[49] Based on these factors, attention must be paid to the credit quality of the debt instrument. In this respect, paragraph 4 of the guideline associates the credit quality requirement to the highest credit rating category awarded by recognised CRAs. Such a requirement operates in the event of credit rating being provided by CRAs, otherwise an equivalent

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[46] ESAs, *supra* note 34.

[47] ESMA, *CESR's Guidelines on a Common Definition of European Money Market Funds*, CESR/10-049 (2010).

[48] *Id*, while STMMFs are allowed to invest in securities with a residual maturity of less than, or equal to, 397 days and have a portfolio-weighted average maturity that does not exceed 60 days, MMFs are not subjected to the same maturity restriction provided that their portfolio-weighted average maturity does not exceed six months.

[49] ESAs, *supra* note 34.

quality for an unrated instrument will be determined through the management company's internal rating process. On the other hand, as to MMFs, paragraph 2 of Box 3 states that MMFs may hold sovereign issuance provided that it is of investment grade quality.[50]

Paragraph 4 of Box 2 and paragraph 2 of Box 3 of the ESMA guidelines have been the subject of review. The changes applied by the ESMA stimulate the following reflections. Both paragraphs have been re-worded in such a way as not to give exclusivity to the external credit ratings to the detriment of other factors that the management company should consider for the determination of credit quality.[51] Such an amendment would have made sense if there had not been any warnings in the guidelines as to the necessity of avoiding giving primacy to external credit ratings for the determination of credit quality. In reality, these warnings were already present in the explanatory notes included in the 2010 ESMA's guidelines: 'in carrying out its diligence, the management company should not place undue weight on the credit rating of the instrument'.[52] Additionally, the explanatory text encouraged the monitoring of the credit quality of the money market instruments on an ongoing basis and not only at the moment of the purchase. Significantly, in the event of rating downgrades, corrective actions should be taken into consideration by the management company in the best interests of the clients.[53]

These explanatory notes were already mitigating the potential risk of over-reliance which, according to the ESMA's 2014 review, would stem from paragraph 4 of Box 2 and paragraph 2 of Box 3. Based on this, it may be argued that there was no need for intervention on this guideline. This raises the question of whether the 2010 CESR's guidelines on European MMFs could really carry the risk of over-reliance as claimed by the ESMA. The answer could be positive in the absence of mitigating warnings, but given that the warnings were already set out in the guidelines, the answer may be negative. For these reasons, the applied amendments appear to be a re-formulation of a set of guidelines which did not appear, per se, to carry the risk of over-reliance due to the fact that asset managers were warned not to give exclusivity to the credit ratings for credit risk assessment.

5. The Risk of Over-reliance in EU Financial Law

The EIOPA has not identified any recommendations or guidelines which contain credit rating references posing a risk of mechanistic reliance.[54] The outcomes of the ESA's reviews, in particular the ESMA's and EIOPA's review, raise some questions that apply to the investigation that the Commission is expected to complete by 2020 under Article 5(c) of CRA Regulation III. The contents of this rule are not dissimilar to those in Article 5(b) involving the ESAs. The only difference is found in the broadest term assigned to the Commission to conduct its review. The Commission will have to review and identify those credit ratings references in EU law which can cause undue reliance and, by January 2020, repeal them, provided that valid alternatives are found. Since it has been mentioned that the EIOPA did not find any credit rating references in its guidelines, and while it has been argued that the ESMA guidelines do not carry, per se, any risk of over-reliance, it is worthwhile to discuss the extent to which the Commission's review of the credit rating references in EU law might lead to the same results. To this end, it is necessary to investigate the hardwiring of credit ratings into EU

[50] *Id*.
[51]*Id*, at 17: 'Where one or more credit rating agencies registered and supervised by ESMA have provided a rating of the instrument, the management company's internal assessment should have regard to, inter alia, those credit ratings. While there should be no mechanistic reliance on such external ratings, a downgrade below the two highest short-term credit ratings by any agency registered and supervised by ESMA that has rated the instrument should lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of high quality'.
[52] *See* ESMA *supra* note 47.
[53] *Id*.
[54] *See* ESAs, *supra* note 34, at 13: 'EIOPA has not identified any guidelines, in force or currently under development, to be used as an example of mechanistic reliance'.

law. In practice, it must be assessed the role of credit ratings in the EU's legislation before the ongoing reforms which took place in the aftermath of the 2007-2009 financial crisis. This will fulfil the purpose of the present analysis, that is, to assess the extent to which credit ratings are embedded in EU law and whether such references confer a primacy status to credit ratings in such a way as to be the exclusive benchmarks for assessing creditworthiness.

5.1.Banking

Starting with the banking sector it must be observed that the CRD, in its early framework, already provided some incentives for more internal risk analysis so as to counterbalance the use of external credit ratings. Firstly, the possibility of using the IRB approach, per se, acted as an incentive to perform more independent credit risk assessments since, as the Commission stressed 'the CRD requires credit institutions to have their own sound credit granting criteria and credit decision processes in place. Basing rating decisions solely on external credit rating agency ratings does not fulfil this requirement under the EU banking legislation'.[55] Secondly, it is worth noting that Annex VII, part 4, item 18 of the earlier framework stated that if a credit institution uses external ratings as primary factors determining an internal rating assignment, the credit institution shall ensure that it considers other relevant information.[56] Therefore, external ratings could be used as primary factors for determining an internal rating but not as exclusive benchmarks. They had to be complemented with other information.

Considering that both the early and new CRD frameworks incorporated incentives for autonomous credit risk analysis, references to credit ratings do not seem, ipso facto, to pose serious risks to over-reliance.

5.2 Insurance

The early EU framework on the supervision of insurance and reinsurance undertakings did not contain any provision referring to credit ratings.[57] Recently, this regime has been amended through the introduction of Directive 2009/138/EC (the so-called Solvency II framework directive), which introduces risk-oriented solvency requirements for insurance and reinsurance undertakings. Solvency II deals with credit risk, and capital requirements are calculated either through a standard formula or through the undertaking's internal model which is subject to supervisory approval.[58] There are no references to external credit ratings in the Solvency II framework. However, on 10 October 2014 the Commission issued a Delegated Act containing implementing rules for Solvency II.[59] In greater detail, Commission Delegated Regulation 2015/35 refers to the credit ratings provided by ECAI. Article 4 states that insurance and reinsurance undertakings may use external credit ratings for the calculation of the solvency capital requirements in accordance with the standard formula only when they have been issued by an ECAI or endorsed by an ECAI under CRA Regulation I. Nonetheless, Regulation 2015/35 takes into consideration the risk of over-reliance on credit ratings by specifying that they cannot be regarded as exclusive parameters for the purposes of calculating capital requirements.[60] Consequently, the new regulation implementing the Solvency II framework is in line with the FSB principles and, in theory, should not pose any over-reliance threat.

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[55] Commission Impact Assessment, *supra* note 27.
[56] *See* Directive 2006/48/EC, 2006 OJ (L 177/1).
[57] *See* Articles 27 to 31 of Directive 2002/83/EC, 2002 OJ (L345/1); Article 1 of Directive 2002/13/EC, 2002 OJ (L77/17); and Articles 37 to 39 of Directive 2005/68/EC, 2005 OJ (L323/1).
[58] See Articles 100 to 127 of Directive 2009/138/EC (Solvency II), 2009 OJ (L 335).
[59] Commission, *Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance* OJ L 12/3 (2014).
[60] *Id*, Recital 5.

5.3.Pensions

Similar conclusions apply to the pension sector. In the EU, pension funds are regulated under the Institution for Occupational Retirement Provision Directive (IORP).[61] This directive does not contain any reference to credit ratings. As already stressed by the EIOPA, this a sector in which legislation has never contained any credit rating references.

5.4.Investment funds

In the EU the area of collective investment schemes covers four types of harmonised investment funds: Undertakings for Collective Investment in Transferable Securities (UCITS); Alternative Investment Fund Managers (AIFM); European Venture Capital Funds (EuVECA); and European Social Entrepreneurship Funds (EuSEF). As mentioned above, the UCITS Directive 2009/65/EC and AIFM Directive 2011/61/EU have been amended by Directive 2013/14/EU in relation to the risk of over-reliance. However, with specific regard to UCITS, it can be noticed that even before the current legislation credit ratings were not the exclusive tools for assessing credit risk. In this respect, reference is to be made to Directive 2007/16/EC implementing Council Directive 85/611/ECC on the coordination of laws, regulations and administrative provisions relating to UCITS as regards the clarification of certain definitions.[62] For instance, Article 6 listed the criteria for assessing the eligibility of non-listed money market instruments issued by 'an establishment which is subject to, and complies with, prudential rules considered by competent authorities to be as stringent as those laid down by community law'. In essence, this provision set out four, non-cumulative, criteria to be met by a money market instrument to be eligible for an investment by a UCITS. The third of these criteria requires the issuer of said instrument to obtain 'at least investment grade rating'.[63] It is submitted that such a provision only identified an instrument as being 'eligible' for investment but not 'suitable' and therefore it was not to be regarded as encouraging excessive reliance to the detriment of one's own risk analysis.[64] Furthermore, Article 10 referred to credit ratings to determine whether transferable securities or money market instruments included a derivative component. According to Article 10, one of the non-cumulative criteria to be used to verify whether the host security (money market instrument) embedded a derivative was whether the performance of the money market instrument was sensitive to changes in the credit rating of the underlined index or asset.[65] As in Article 6, credit ratings were just one criterion. Asset managers were neither limited nor discouraged from conducting their own risk analysis.

Considering the recent amendments applied to the UCITS and AIFM directives, which include the principle to reduce over-reliance through the encouragement of independent credit risk analysis, the outcomes in this sector are not dissimilar to those relating to the CRD framework. There was already an *ex ante* (and there is an *ex post*) mitigation of the role of the credit ratings.

5.5.Investment firms

With regard to investment firms, it is worth mentioning the debate as to the credit rating reference incorporated in Article 18 of Directive 2006/73/EC implementing Directive 2004/39/EC (MIFID I). Article 18 requires qualifying money market funds (QMMF) to invest in high quality money market instruments to achieve their primary investment objective which is to maintain the net asset value of

[61] Directive 2003/41/EC, 2003, OJ (L 235/10).
[62] Directive 2007/16/EC, 2007 OJ (L79/11).
[63] *Id*.
[64] Commission Impact Assessment, *supra* note 27.
[65] OJ (L79/11), *supra* note 62.

the undertaking either constant at par (net of earnings) or at the value of the investor's initial capital plus earnings. Under this rule, high money market instruments are those which receive the highest credit ratings by competent CRAs.[66] An instrument not rated by any competent CRA shall not be regarded as a high quality one.

This reference to credit ratings was controversial. It was argued that the requirement could potentially exclude all UCITS money market funds which did not rely on specific credit ratings in their investment process from the market of managing investment firms' clients money.[67] Specifically, the risk was that a money market fund could be excluded from becoming a QMMF when it did not rely on competent CRAs but conducted its own risk analysis sufficient to demonstrate that the instrument carried an acceptable level of risk.[68] Significantly, the rule appeared to give undue primacy to the credit ratings. Nonetheless, contrariety was expressed with regard to amending the credit rating reference on the grounds that: 'an independent credit rating protects investors by limiting the fund's ability to chase higher yields through riskier securities based on the fund manager's own subjective assessment'.[69] Hence, the elimination of the credit rating reference from Article 18 of the MIFID would have hampered the possibility for money market fund investors to rely on a common standard for investment quality. Accordingly, it was suggested that only the requirement to refer to 'competent CRAs' would be eliminated, but ultimately there were no changes. However, it must be noticed that MIFID I will be repealed and recast by Directive 2014/65/EU and Regulation 600/2014 (so-called MIFID II), which the Commission issued in July 2014. Both the directive and regulation do not contain references to credit ratings.[70]

5.6.Disclosure requirements for securities

References to credit ratings are also included in the EU rules governing the publishing of a prospectus when securities are offered to the public or admitted to trading on a regulated market. Annex V of Regulation 809/2004 implementing the Prospectus Directive 2003/71/EC lists the information that the prospectus should include with regard to the securities being offered or admitted to trading.[71] To this end, Paragraph 7.5 of Annex V requires an indication the credit ratings assigned to an issuer or its debt securities at the request of, or with the cooperation of, the issuer in the rating process. If the rating provider has previously published an explanation of the meaning of the ratings, this should also be included according to Paragraph 7.5.[72] These rules simply refer to instruments which received their solicited credit ratings. Nonetheless, there are no references imposing the use of external credit ratings as an eligibility condition for the security offering. Credit ratings are simply mentioned among the information to be written in the prospectus. Accordingly, such a reference cannot be identified as carrying the risk of sole and mechanistic reliance on external credit ratings.

6. Appraising the Regulators' Use of Credit Ratings in EU Law

The result of the ESAs' review work, as well as the analysis of the hardwiring of credit ratings in EU law, drew attention to the following outcomes: either there are no credit rating references or credit ratings are not used as the exclusive benchmarks for assessing credit risk because of explicit warnings

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[66] *See* Directive 2006/73/EC, 2006 OJ (L 241/26).
[67] European Fund and Asset Management Association (EFAMA), *Tackling the Problem of Excessive Reliance on Ratings* (2008).
[68] *Id*.
[69] *See* Bundesverband Investment und Asset Management e.V. (BVI), *DG Markt Services Document: Tackling the Problem of Excessive Reliance on Ratings* (2008).
[70] *See* Directive 2014/65/EU (recast), 2014 OJ (L 173/349); *see* also Regulation (EU) 600/2014, 2014 OJ (L 173/84).
[71] Directive 2003/71/EC, 2003 OJ (L 345/64); Regulation 809/2004, 2004 OJ (L 215/3).
[72] *Id*.

to this end. Importantly, such outcomes should not be referred to the post-crisis reforms of the EU's financial legislation which, inter alia, addressed the issue of over-reliance, but mainly to the pre-crisis legislation. Therefore, before the post-crisis reforms there was already a conscious use of credit ratings by European regulators. These were among several factors to be taken into consideration for assessing credit risk. Significantly, no exclusivity to the credit ratings was given by the European regulators. Based on this, it can be concluded that there was no risk of over-reliance deriving from the inclusion of credit ratings in EU law. However, it may be objected that the EBA identified this risk in some of its guidelines. In this respect, it must be emphasised that the banking sector has always been earmarked as the one which boasts the most pervasive use of credit ratings because of the reference to them under the SA of the Basel framework.[73] From a European perspective, this can be noticed in the Capital Adequacy Directive and the Banking Directives of 2006 which ultimately implemented the Basel II framework and its SA approach. However, it must be observed that the 2006 Capital Adequacy Directive constituted the enlargement of the earlier 1993 Capital Adequacy Directive which first pioneered the regulatory use of credit ratings in the European Banking Regulation. From that moment until the issuance of the 2006 directives, almost all the EU Member States referred to credit ratings in their prudential supervision of banks in order to define eligible debt securities for the calculation of the capital requirements for specific interest rate risk.[74] Nonetheless, as mentioned, the earlier EU CRD framework already had incentives for the use of internal systems so as to conduct an analysis of creditworthiness not exclusively based on the credit ratings. Accordingly, even in the sector in which credit ratings are most often used, the European regulators tried to strike an appropriate balance between the use of internal and external means of assessing credit quality. This approach was also maintained in the other pieces of primary or secondary EU legislation in which references to credit ratings were included.

In comparison to other legal systems in which credit ratings can be considered as being regarded so hardwired that they have been finally used as exclusive tools for credit risk analysis, this is a significant difference. For instance, in the US, the Banking Act of 1936 marked a first in the use of credit ratings in legislation, while in the 1970s the so-called Net Capital Rule paved the way for the widespread use of credit ratings which has since led to the characterisation of the US as the country with the highest rate of use of credit ratings in legislation, regulation and supervisory policies.[75] This explains the amendments that the US federal agencies are required to apply to their own legislation according to the letter and spirit of section 939A of the Dodd-Frank Wall Street Consumers Protection Act.[76] The approach to credit ratings under section 939A sounds harsh vis-à-vis the approach set out in European CRA Regulation III. In fact, while the US federal agencies are required to review, remove and replace credit rating references with valid alternatives,[77] the ESAs and the Commission are required to identify only those credit rating references which may induce mechanistic reliance. This demonstrates the different ways of referring to credit ratings by the US and EU regulators. In other words, if the European regulators aim at selecting only those credit rating references which cause undue reliance by investors and market participants, this means that credit ratings will still be retained in legislation where necessary. This also means that their presence in legislation was equilibrated to the extent that the users of credit ratings were incentivised to take them as complementary, and not as unique, sources of information. This approach was pursued in EU law even prior to the post-crisis regulatory debate on the CRAs in which the phenomenon of over-reliance was highlighted.

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[73] BCBS, *The Joint Forum, Stocktaking on the Use of Credit Ratings*, 3 (2009) *available at* http://www.bis.org/publ/joint22.pdf.
[74] Andreas Kruck, *Private Ratings Public Regulations: Credit Rating Agencies and Global Financial Governance*, 80 (Palgrave MacMillan 2011).
[75] Frank Partnoy *supra* note 1.
[76] *See* Dodd-Frank Act § 939A ("Review of Reliance on Ratings").
[77] *Id*.

All things considered, the risk of mechanistic reliance deriving from the credit rating references in the EU's financial legislation does not seem to be extreme. Finally, in the context of the present discussion it should be mentioned that the risk of over-reliance might be concrete in the event that exclusivity to credit ratings was given in the Member States' domestic legislation implementing the European directives. However, the current stance towards the elimination of this risk and the incentive to use the credit ratings as one among several factors to assess credit risk should be the impetus for framing appropriate implementing legislation at the national level. In any case, there are sufficient elements to affirm that the use of the credit ratings in the EU's financial legislation was either marginal or absent. Where references were made, these found an adequate counterbalance in the warnings not to interpret them as exclusive parameters.

7. Conclusion

The credit rating references in EU law do not carry the risk of over-reliance. This conclusion can be drawn from the three results that the present analysis has found. Specifically, it has been shown that some pieces of legislation do not contain credit rating references while others refer to the credit ratings as being among several factors to be taken into consideration in credit risk analysis, while others still provide explicit warnings not to rely exclusively on credit ratings as substitutes for one's own independent credit risk assessment and due diligence. This approach to credit ratings characterised the EU's financial legislation even before the 2007-2009 financial crisis and is currently being strengthened as a result of the post-crisis reforms. Despite this conclusion, the review work that the Commission will complete in accordance with its timescale remains to be seen. Finding valid alternatives to credit ratings is also part of the work of the Commission once it has identified and removed those credit rating references which may induce mechanistic reliance.[78] Identifying valid alternatives to credit ratings is a challenging task. Nonetheless, this could be avoided should the Commission conclude that credit rating references in EU law do not pose a serious risk of over-reliance. However, it will be interesting to analyse any possible reference that the Commission may consider as posing a risk of over-reliance. However, there is a high degree of subjectivity in this case. At the beginning, it was highlighted that the phenomenon of over-reliance was introduced but not clearly defined. This was a real issue since the ESAs had finally to set a definition in order to start their review work. In the event that the Commission identifies some critical credit rating references in EU law, it will have to base it on the definition of mechanistic reliance provided by the ESAs in order to remove and replace them with possible alternatives. To what extent can those who are regarded as being at risk of over-reliance, that is to say, the users of credit ratings agree with the Commission's choice? To what extent do the users of credit ratings agree with the assertion that they may over-rely on them? This will be a matter for further discussion in accordance with the results of the Commission's review. At this stage, it appears that the EU regulators did not over-emphasise credit ratings in such a way as to facilitate a misperception of them as constituting 'seals of approval' of creditworthiness.

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[78] The Commission is expected to submit a report to the European Parliament and the Council by the end of 2015. This should update on the steps to be taken for the deletion of credit rating references provided that valid alternatives to credit ratings are found. *See*, Directorate General Internal Market and Services (DGIMS), *EU Response to the Financial Stability Board (FSB)-EU Action Plan to Reduce Reliance on Credit Rating Agency (CRA) Ratings*, Staff Working Paper (May 2014); *See* also Andreas Horsch, *Regulation of Credit Rating Companies: An Economic Point of View*, 25 EUR. BUS. L. REV. 2, 227 (2014).