



European Securities and
Markets Authority

Call for Evidence Investor Response

Competition, choice and conflicts of interest in the credit rating industry



Responding to this call for evidence

This call for evidence should be read by all those involved in the credit rating industry. It is particularly targeted at the following market participants and the groups and trade associations who represent them:

1. Corporate and sovereign issuers of financial instruments requesting credit ratings.
2. Credit rating agencies issuing credit ratings.
3. Institutional investors and other users of credit ratings.

There are specific questions for corporate and sovereign issuers in section 4 of the call for evidence, followed by questions for credit rating agencies in section 5 and for investors in section 6. ESMA invites respondents to provide information about each relevant set of questions using the template response forms provided for each group.

Responses are most helpful to ESMA where they clearly indicate which question is being answered and provide evidence in support of the response, such as concrete examples of practices experienced, data or costs estimates.

ESMA will consider all responses received by **31 March 2015**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the call for evidence, unless you request otherwise. Please clearly and prominently indicate in your submission any part that you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

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Acronyms used

CEREP	ESMA Central Repository for publishing credit rating activity and performance statistics
Commission	The European Commission
CRA	Credit rating agency
CRA Regulation	Regulation 1060/2009 on credit rating agencies as amended
ESMA	European Securities and Markets Authority
EU	European Union

Executive Summary

Reasons for publication

ESMA is publishing a call for evidence to collect information from market participants about the functioning of the credit rating industry and the evolution of the markets for structured finance instruments as required by Regulation 1060/2009 on credit rating agencies as amended (the CRA Regulation). ESMA is seeking evidence about competition, choice and conflicts of interests in the credit rating agency industry in general as well as about the impact of a number of specific provisions of the CRA Regulation.

Contents

This template response form contains the questions to be answered by investors and other users of credit ratings found in Section 6 of the call for evidence.

Respondents may need to disclose commercially sensitive information to ESMA in order to answer some of the questions asked. ESMA intends to present confidential information in anonymised and aggregated form in its Technical Advice so that individual respondents cannot be identified. In order to facilitate this process, ESMA therefore asks respondents to clearly indicate which parts of the answers to each question they believe to contain confidential information.

Next Steps

ESMA will carefully consider all responses to the Call for Evidence received by the deadline of 31 March 2015. The evidence obtained will be analysed by ESMA as part of the development of the Technical Advice to be provided to the European Commission pursuant to Articles 39(4) and 39(5) of the CRA Regulation.

6 Questions for investors and other users of credit ratings

6.1 About your organisation

1. The questions in this part aim to obtain information about the nature of the organisation you represent and the different markets in which you are active. This information will help ESMA to put your responses in context and to compare responses from similar respondents.

Q1: Please provide the name of your organisation.

AFG

The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. More than 630 management companies are based in France. AFG members manage more than 3,000 billion euros, making in particular the Paris fund industry a leader in Europe for the financial management of collective investments (with 1,500 billion euros managed from France, i.e. 19% of all EU assets managed in the form of investment funds). In the field of collective investment, our industry includes – beside UCITS – the whole range of AIFs, such as: employee savings schemes, regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment funds. AFG is an active member of the European Fund and Asset Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

Q2: Please explain whether you invest in instruments with credit ratings at local, national, EU and/or global level. If your organisation invests in instruments at EU or global level, please provide a list of the jurisdictions covered.

Our members, investment managers, invest in instruments with credit ratings at local, EU and global levels.

Q3: Please explain whether you invest in CRAs or related companies, and if so, provide a list of these and your percentage shareholding in each.

Our members may be in a position to invest in CRAs or related companies as in any other underlying company that is eligible and suitable within the vehicle's specific investment target.

6.2 Due diligence and use of credit ratings

2. The CRA Regulation aims to increase investor protection and reduce reliance on credit ratings through a number of transparency and disclosure requirements.
3. The questions in this part aim to understand what impact the CRA Regulation has had on how you use credit ratings in the course of your business and whether there is other information which you could use to assess credit risk instead of credit ratings.

Q4: Please explain the due diligence process you follow and the types of information you consider in order to decide which instruments to invest in.

AFG has always expressed in favour of reducing reliance on credit ratings. Indeed, we were unhappy when the 2010 elaborated ESMA's Guidelines on money market funds imposed eligibility rules based directly on external credit ratings. These guidelines also imposed that all agencies rating the instrument be taken into account, which had put the asset manager in a captive position.

We thus welcome the CRA Regulation impact on rules that were previously establishing a mechanic link to ratings.

In the meantime, AFG has always recognised the importance of external credit ratings on debt instruments (especially corporate debt instruments) as a tool available in the manager's toolkit as well as a common language with investors, counterparties and other third parties.

Regarding the investment in rated funds, our investors in the French market usually perform their own due diligence on both manager and fund and thus make little use of fund ratings. In the money market funds' market, French VNAV funds are usually not rated, while investors in other jurisdictions' CNAV vehicles are offered AAA rated CNAV vehicles. Some rules of rating agencies for AAA MMFs may have a mechanical effect of reliance by linking the vehicle's rating to ratings on underlying instruments. We thus regret that some rating agencies expressed views on types of MMFs in the European market without clearly specifying the risk of inherent conflicts of interest when some types of funds are historically being rated (and thus generating business for rating agencies) and others not.

It should be recalled that the assessment of the credit quality of an issuer is subjective. While quantitative metrics are part of the criteria used in the evaluation process, they are nevertheless information from the past. Projections of these information are based on assumptions, anticipations, that by definition can differ from one analyst to another. On the other hand, qualitative measures (management effectiveness, strategy...) are subjective and

despite they could be judged “good” or “bad”, only the future will tell what was the right answer.

External ratings may be an input on the process followed by managers.

Credit analysis plays a key role in the management of investment funds. The success in anticipating the evolution of the credit quality of an issuer is a major component in the creation of performance and is an important element of the reputation of an asset manager.

The difference of views from market participants is a key pillar of the functioning of financial markets. The diversity of views between managers for the same issuer is a natural result of this process.

Of course, the risk of having strong divergences of views between managers is mitigated through the reporting on the credit quality of the funds to their clients and regulators so that they can be compared with recognized, harmonized and coherent rating scales.

It should be mentioned here the importance of investment research that is used by investment managers in their assessments. Unfortunately, the current ESMA’s advice relating to investment research within MIFid 2 would adversely impact on the availability of this research, particularly relating to small and medium enterprises. ESMA’s advice puts at high risk the fact that this research should continue to be available to the whole range of asset managers, both large and small, and from both independent research providers and those who also provide execution services.

Q5: Please explain whether your overall use of credit ratings in the course of your business or in making investment decisions has increased or decreased since 2010, giving reasons for your answer.

We believe that recent trends encouraged our members in their internal credit analysis capabilities. Mechanistic reliance is now discouraged in the regulation, which is positive, but this should not mean that asset managers are supposed to be replacing the work done at the rating agencies. Investment management and rating is not the same job.

Q6: Please explain whether and if so what information you use to assess the quality of credit ratings.

AFG believes that it is not part of our members' job to assess the quality of credit rating. They make independent assessments of issuers and issues before investing. They may have a more positive or more prudent view than a CRA but that does not imply that they contest the quality of the rating issued by a CRA following known and supervised methodologies.

Q7: Please explain whether and if so to what extent you use internal rating models in addition to or instead of credit ratings in your business or investment decisions.

Our members, investment managers, may use external ratings as an input within their own assessment. However, there is not an unique process that prevails in the industry (as explained in our response at question 4). Thus, we believe there should not be an unique model, nor an obligation to have a rating on the model of CRAs. Few of our members have scales of ratings, most of them perform an assessment allowing them to express an opinion more as an authorization to invest up to a given limit than as a level of rating. If some of our members may use a quantitative approach, we do not consider that the word "rating model" reflects the process they follow.

In addition, we kindly ask ESMA to avoid the misleading wording "internal rating models". According to Article 5a of the CRA III Regulation, users of ratings shall only make their "own credit risk assessment" and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument. Internal rating models are not comparable with the own credit risk assessment of any user of an external rating.

In view of the circumstances that external ratings can only be one factor among others in the investment decision process or risk management process of an asset manager, there is no need for more alternative approaches such as analysis of the underlying methodologies of the ratings. This applies even more in light of the fact that the exact details of rating methodologies or for a single rating decision are mostly not public or our members can only use these information in return for a fee.

We therefore request ESMA that any proposals for a review of the CRA Regulation should be set in a manner that no further expense or costs for rating data are incurred, to the detriment of our clients.

It should also be clarified that it is the decision of the users of credit ratings (such as investment management companies) if and which method, rating or CRA is relevant for the internal credit assessment.

Q8: Do issuers or CRAs currently give you more information about how their credit ratings are developed, issued and revised and how their credit ratings compare to the market performance of the rated instruments than they did before 2010? If so, does this additional information make it easier for you to understand and compare:

(1) the ratings products and other services being offered by different CRAs; and

Our members think that CRAs actively promote their products as they did before 2010.

(2) the quality of the credit risk analysis carried out on rated instruments?

Transparency on rating processes has globally improved over the last five years.

Q9: Are there other sources of information which you would use to make investment decisions instead of credit ratings?

Our members may use many other sources such as report and accounts of the issuer, prospectus of the issue, press releases, external and internal research... and consider CRA ratings as one source of information among many others. Ratings published by CRAs are not decisive in the investment process, except for those portfolios where rating limits are explicit.

Q10: Please explain whether and if so how your business uses unsolicited credit ratings, giving reasons for your answer.

In general, our members tend not to consider unsolicited ratings as being of the same quality as ratings published with the authorisation of the issuer.

Q11: Please explain whether, and if so how, your approaches to the issues raised in questions 4-10 above have changed since 2010.

We would say that our members see a clear distinction between the historical activity of CRAs on rating debt instruments, which is a reference in the market, and other developments/activities such as rating of structured finance or funds. It is generally not considered that the traditional debt instruments rating activity would have failed at the end of the first decade of the 21st century. On the contrary, we esteem one should be very cautious when referring to CRAs

activities in different domains such as structured finance deals or funds ratings.

6.3 Independence and quality of credit ratings

4. One of the aims of the CRA Regulation is to increase the quality of credit ratings by seeking to reduce the conflicts of interest inherent where issuers pay for the rating of their financial instruments.¹
5. The questions in this part aim to understand the different ways that CRAs can seek payment for the credit ratings issued and to assess the impact of the CRA Regulation on increasing the quality and independence of credit ratings.

Q12: Please explain in which circumstances you currently pay for credit ratings. If you do not currently pay for credit ratings, please explain whether, and if so under which circumstances, you would be willing to pay for credit ratings.

Many of our members are subscribers to largest CRAs and receive their ratings. There is a critical need to use ratings for reporting as requested by investors. Our members complain that the exact terms and conditions of these subscriptions are not always satisfactory regarding the definition of what is subject to property rights (as opposed to public information), the level of responsibility of the CRAs and the extent of the licence.

With the coming into force of Solvency 2, asset managers are required to report to insurance clients the external ratings of their holdings and that has raised difficulties. Indeed, according to our members, the vast majority of CRAs would consider that it necessarily implies the subscription to a new licence to become information dispatcher. This is clearly a key concern today. Regulation should not “create” a captive market for CRAs.

Q13: Irrespective of whether you pay for credit ratings, please explain the circumstances in which links or existing relationships between an issuer of a particular instrument and a CRA would have an impact on how you would use a credit rating of that instrument.

According to our members, they would actually rather disregard ratings published by a subsidiary or a linked company of an issuer. Otherwise, they would not consider that long standing relationships (other than capital) should be regarded as creating a potential conflict of interest between a CRA and an issuer.

¹ See Recital 10 of Regulation 462/2013 of 21 May 2013.

Q14: Please explain whether the quality of credit ratings has increased or decreased since 2010, giving reasons for your answer.

Generally, our members feel that the quality of traditional debt instrument rating has always been good and remains of quality and confidence.

As for the rating of other products such as structured deals or funds, our members are less concerned. We consider fund ratings for instance more like a label than a genuine rating. Using the same scales on very different activities may be considered somewhat confusing.

Q15: Please explain what, if any, further measures could be taken to increase the quality of ratings, giving reasons for your answer.

Our members feel generally comfortable to use traditional activity ratings where CRAs have proven expertise, i.e. debt instrument ratings. Their developments in other areas should maybe be accompanied by clear disclaimers for investors or even refer to different scoring/scales so that there would not be any risk of confusion. Indeed, if an investment manager has ultimately the knowledge to appraise an investment disregarding the rating, other investors may be less qualified to assess by their own and might be tempted to place wrong expectations on a high score.

6.4 Multiple credit ratings

6. The 2013 amendments to the CRA Regulation introduced a number of requirements on issuers and sponsors of structured finance instruments to obtain multiple credit ratings. These requirements are set out in Articles 8c and 8d of the CRA Regulation.
7. Article 8c of the CRA Regulation requires issuers to obtain at least two credit ratings for structured finance instruments. This obligation was introduced with the aims of restoring market confidence in complex financial instruments and reducing reliance on single credit ratings.²
8. Article 8d of the CRA Regulation aims to increase competition between CRAs by encouraging issuers to use smaller CRAs when they use multiple CRAs. Article 8d states that where issuers or related third parties intend to appoint at least two CRAs to rate an issuance or entity, they shall consider appointing at least one CRA with no more than 10% of the total market share where possible (hereinafter 'small CRA').

² See Recital 28 of Regulation 462/2013 of 21 May 2013.

9. The question in this part aim to understand whether these provisions have achieved their objectives and the impact they have had on your business.

Q16: Please explain what impact multiple credit ratings of the same instrument have on your investment or business decisions.

We strongly believe that the suggestion to consider multiple ratings is not relevant. The real point is to ensure that investment decisions are not made with an excessive reliance to ratings. It is far better to consult zero ratings and proceed with a thorough internal credit assessment than several external ratings with no personal judgement. Our members conduct their assessments of instruments they intend to invest and may consider ratings as one among other information sources.

We call to mind that as an industry we were unhappy with the obligation once set by ESMA for European MMFs to take into account all CRAs that have rated the instrument.

Q17: Please explain whether in your view, issuers should be obliged to obtain multiple credit ratings in respect of some or all asset classes and if so, how many ratings per asset class should be required.

No. If we want to incentivize investors to conduct their own credit assessment, we should not suggest that ratings can be sufficient to do it provided they are multiple.

Q18: Please explain whether you would use ratings from a small CRA, giving reasons for your answer. Please explain whether, and if so how, your approach to this issue has changed since 2010.

We do not favour positive discrimination among CRAs. Credibility of the CRA is key when using or referring to a rating. This is not a matter of size but of process and means made available. We believe efforts should be concentrated on the quality of the service provided by natural players.

Q19: Please explain whether you would use ratings from a CRA who has not previously rated a particular asset class, giving reasons for your answer. Please also explain whether, and if so how, your approach to this issue has changed since 2010.

In the absence of previous track record of a CRA in an asset class, our members refer to its process and organisation to establish whether or not it is possible to work with it.

6.5 Disclosure requirements for structured finance instruments

10. The 2013 amendments to the CRA Regulation sought to increase transparency through the introduction in Article 8b of a joint obligation on issuers, originators and sponsors to publish information on the credit quality and performance of the underlying assets of structured finance instruments.

11. The expression '*structured finance instrument*' is defined as a financial instrument or other assets resulting from a securitisation transaction or schemes '*whereby the credit risk associated with an exposure or pool of exposures is tranced, having both of the following characteristics:*

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme'.³

12. Commission Delegated Regulation 2015/3 of 30 September 2014 sets out the disclosure requirements for issuers, originators and sponsors of structured finance instruments.⁴ Although this Delegated Regulation will only apply from 1 January 2017, its aim of improving transparency is clear. In this part ESMA therefore wishes to understand the benefits and costs of extending these disclosure obligations to other asset classes.

Q20: Please explain whether the requirements of the CRA Regulation for issuers, originators and sponsors to make information available through a website, including information regarding the creditworthiness and performance of structured finance instruments, are sufficient or should be extended to other asset classes, giving reasons for your answer. If so, please explain to which products this obligation should be extended.

The question of transparency on securitisations is not limited to CRAs. It is of paramount importance, but relates to the regulation of securitisations and the need for the definition of high quality deals.

If CRAs publish on their website information on structured instruments, we can only agree and encourage it.

³ Article 4(1)(61) of Regulation No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation No 648/2012, OJ L 176, 27.6.2013.

⁴ OJ L 57, 6.1.2015, p. 2.

However our members do not necessarily consider that it should be extended to other asset classes. In addition, we believe that it should not reduce the requirements that issuers or originators be more transparent on those instruments.

6.6 Mandatory rotation

13. The 2013 amendments to the CRA Regulation introduced a mandatory rotation provision for CRAs issuing ratings on re-securitisations, which can be found in Article 6b of the CRA Regulation. Article 6b provides that CRAs may enter into ratings agreements for re-securitisations with a maximum length of four years, after which time they are prevented from rating new re-securitisations with underlying assets from the same originator for a period of four years.
14. The CRA Regulation notes that the implementation of a rotation mechanism should remove the incentive for a CRA to give favourable credit ratings to issuers on the basis of their existing relationships and could encourage other CRAs to start rating these instruments.⁵
15. As the provision was also designed to help stimulate competition, Article 6b2(b) of the CRA Regulation explains that mandatory rotation will cease to apply where at least four CRAs each rate more than 10% of the total number of outstanding re-securitisations.⁶
16. Although this provision has only recently entered into force, the questions in this part are designed to help ESMA understand the impact of this provision and the extent to which it has already been used. They also aim to assess the appropriateness of maintaining a rotation mechanism, whether, and if so how, it should be extended to other asset classes and what impact this would have on issuers and CRAs.

Q21: Please provide details of any experience you have had of this rotation provision to date.

Our members do not have direct experience to share, but more a general concern that rotation is not an appropriate answer to deal with potential conflicts of interest due to a long standing relationship. In our members' view, it relies on an unjustified assumption that CRAs would not be able to keep an independent view on deals of an issuer or originator when they better know its organisation. We believe it is more a question of competition between CRAs and of internal organisation and control within a CRA so as to best cope with the issue of potential conflicts of interests.

⁵ See Recital 12 of Regulation 462/2013 of 21 May 2013.

⁶ See Recital 15 of Regulation 462/2013 of 21 May 2013.

Q22: Please explain whether a 4-year contract term is appropriate for this rotation provision, and if not, what would be an appropriate length?

Our members as users of ratings have no practical experiences at this field, but in general do not support the idea of rotation.

Q23: Please explain whether mandatory rotation should be extended to other asset classes. If so, please:

(1) list the asset classes to be covered and state the appropriate contract length for each;

We do not support the idea of rotation, and thus oppose its extension.

(2) explain whether, and if so why an obligation should be introduced for CRAs to provide a handover file to the incoming CRA at the end of the maximum contract term.⁷

No. The aim of rotation, if any, would be to ensure that there is a new judgement by a new CRA. Transmission of non public information by the exiting CRA to the incoming one would jeopardize this attempt to have a fresh review.

Q24: Please explain, giving reasons for your answer whether, and if so how, the exemption from the mandatory rotation provision should be maintained where at least four CRAs each rate more than 10% of the total number of outstanding re-securitisations.

We do not support the idea of rotation and totally agree with exemptions, especially when they rely on enhanced competition.

6.7 Competition between credit rating agencies

17. The aim of improving the functioning of the markets within the CRA sector was a major driving force behind the development of the CRA Regulation. The CRA Regulation seeks to achieve this aim by stimulating competition between CRAs, through registration and disclosure requirements as well as through specific provisions regarding the use of multiple credit ratings and the mandatory rotation of CRAs.

⁷ See Recital 13 of Regulation 462/2013 of 21 May 2013.

18. The questions in this part aim to collect further information about competition between credit rating agencies and whether competition between CRAs has changed since the CRA Regulation entered into force in 2010.

19. ESMA would also like to take your views as to whether, and if so how, competition between CRAs could be stimulated without having a negative impact on the quality of credit ratings.

Q25: Please explain whether you are aware of any competition between CRAs. If so, please explain on which of the following parameters CRAs currently compete:

- (1) quality of rating;**
- (2) relationship with issuers;**
- (3) investor relationships;**
- (4) by asset class;**
- (5) by price to issuer;**
- (6) by level of rating;**
- (7) through the offer of ancillary or non-ratings services; and/or**
- (8) other (please specify).**

We would say that CRAs compete, even if it is not easy for users to follow precisely how competition occurs. Among criteria for competition, we would mention:

- the visibility of the published rating and the level of confidence the market participants put in it. In that respect process and quality of staff and organisation are the most relevant factors.**
- the price paid by the issuer for services that will seem equivalent in terms of quality.**
- the quality and proximity of the relationship with the issuer: a more pedagogic approach will be preferred to a non disputable unexplained rating which finally is not totally shared with the issuer.**

Q26: If you have been aware of competition between CRAs, please explain whether, and if so how, the nature of competition between them has changed between 2010 and present.

Our members feel that in the field of structured instruments for instance, excesses have been made prior to and during the financial crisis. They believe (and hope) it is no longer the case, but keep a prudent view on ratings of these products and are reserved when it comes to their marketing to investors, not all aware of their underlying significance.

Q27: Should further measures be taken to stimulate competition between CRAs overall and/ or in respect of the rating of particular types of asset class such as structured finance instruments? If so, please explain what measures could be taken without having a negative impact on the quality of credit ratings.

We are of the opinion that any efforts should be concentrated on the quality of the service provided by natural players. Confidence and credibility are key and these are build with time and not with regulation. We consider that CRAs must and will develop competition spontaneously. Thus, we believe that there is no need for further measures to stimulate competition between CRAs, at least as long as they refrain from making excess use of their power (partly enhanced by regulation) to impose unfair prices to rating users or making them unduly pay what should remain public information.

6.8 Other evidence

20. If there is any other evidence or information that you would like to bring to ESMA's attention, please present it here.

Our members consider that the regulation of CRAs is a very good step forward because of the systemic risk that could result from a mechanistic reliance on ratings.

Our members feel that, onwards, :

- the focus should be kept on the risk of excessive reliance on ratings and education of end investors;**
- ratings should not be examined with a prejudiced view of lack of professionalism or necessary conflicts of interest;**
- regulation should address the question of contractual relationship between CRAs and not only issuers but also subscribers to their services; more specifically, reporting under Solvency 2 raises very important questions that should not result in an excessive cost for asset managers or investors and in any case for the end individual client;**
- regulators should also consider the systemic risk that results from the activities of other information key to market stakeholders: data providers do present a systemic risk in our view and should be duly regulated in terms of organisation, responsibility and commercial approach.**