

**BVI comments regarding ESMA's call for evidence  
Competition, choice and conflict of interest in the credit rating industry  
Ref.: ESMA/2015/233**

BVI<sup>1</sup> gladly takes the opportunity to present its views on the call for evidence regarding competition, choice and conflicts of interest in the credit rating industry. Before turning to detailed remarks on the questions for consultation, we would like to draw ESMA's attention to our key issues and concerns.

**Key issues**

The use of credit ratings is only one factor of many in the credit assessment process within the fixed income asset management industry. There is therefore, in principle, no exclusive reliance on credit ratings. However, in respect of over-reliance on credit ratings a legal system is already in place which is designed to avoid over-reliance on credit ratings by investment management companies. The implementation of these rules into the German Investment Act (Kapitalanlagegesetzbuch – KAGB) has been completed since December 2014 at the latest. The law requires internal risk assessment and monitoring of credit or counterparty risk, among others, and requires the management company to assess internally and monitor the quality of both issuers and counterparties. The management company is also required to implement position limits in line with the assessment that are specific to the issuers and counterparties. In these internal assessments, external ratings can only be one factor among others.

Furthermore, our members assume that formulaic reliance on external CRAs in contractual agreements may be dropped whenever the relevant legislator or national competent authorities delete applicable references to ratings (in the EU e.g. rating requirements under the CRD IV regime, Solvency II regime, ESMA guidelines on money market funds). Therefore, the competent national authorities should be explicitly required to review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations.

In this context, we are in favor of moderate supervisory guidelines by national competent authorities as well as by ESMA regarding the implementation, application and monitoring of the CRA Regulation. We see no need for fundamental revision of the current CRA Regulation. However, we kindly ask to review measures which could influence the quality and content of a rating (such as requirements to change the lead rating analyst after certain periods of time).

Ratings are useful and reliable quantitative and qualitative indicators to assess the probability of default and/or expected loss of a rated investment. The benefit lies in independence and neutrality of the CRAs and in transparency of methodology and process. In our view, while there is no need for further regulatory measures to stimulate competition between CRAs, we believe that competition between CRAs and the quality of ratings can be increased by a strict supervisory practice. There should be also a focus on CRA ancillary services, especially rating data feeds, in order to discourage anti-competitive behaviour. In this context we hope that the ESMA operated European Ratings Database will improve transparency

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<sup>1</sup> BVI represents the interests of the German investment fund and asset management industry. Its 88 members manage assets in excess of EUR 2.5 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit [www.bvi.de/en](http://www.bvi.de/en).



from end of 2016 onwards. It is of particular importance that the ERD caters to the needs of institutional investors which use ratings data (i.e. the rating plus the corresponding issue/issuer identification) in bulk. In this context ESMA needs to clarify that the public ratings database can be used also in case of “reuse” of ratings, e.g. in a situation where the outsourced asset manager needs to report the portfolio of the fund, including ratings of individual, to its institutional investors such as banks and insurance undertakings which are required by regulation to pay attention to ratings. It is not acceptable if such use of publicly available ratings data would enable the CRAs to sell more data reporting licenses to asset managers and their institutional investors than is the case today.

ESMA should therefore monitor all registered CRAs as part of its on-going supervision that they properly incorporate the requirements and the objectives of the CRA Regulation into their working practices and remove any practices and procedures which conflict with these.

### Specific comments

We would like to answer ESMA's questions as follows:

**Q1.** *Please provide the name of your organisation.*

BVI Bundesverband Investment und Asset Management e.V.

**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.*

BVI represents the interests of the German investment fund and asset management industry. Its 88 members manage assets in excess of EUR 2.5 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. Our members invest in equity, fixed income and real estate instruments at local, national, EU and global level. Please find attached an overview of the markets sectors covered by our members investment funds (**Annex**).

**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.*

We are not aware whether and to what extent our members invest in CRAs or related companies. ESMA should receive this kind of information from the CRA itself or from other official bodies other than ESMA (AIF reporting) to whom our members report the composition of the funds they manage (ECB/Deutsche Bundesbank).

**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.*

Investment management companies are obliged to ensure a high standard of diligence in the selection and ongoing monitoring of investments, in the best interests of the investors of the fund and the integrity of the market. In principle, our members use credit ratings as only one parameter when making their



investment decisions. They may only make decisions, if they have the appropriate professional expertise and knowledge of the assets in which investment funds are invested. They have to ensure that the managed fund is only invested in financial assets whose risks can be adequately assessed, monitored and managed by the risk management process adopted by the company. In order to ensure that investment decisions are carried out in compliance with the set investment strategy and risk limits of the investment fund. Investment management companies have to establish and implement written policies and procedures on due diligence. Moreover, before carrying out investments, management companies are obliged to take into account (where appropriate) the nature of the foreseen investment, formulate forecasts and perform analyses concerning its contribution to the fund's portfolio composition, liquidity and risk and reward profile. These analyses are supported by reliable, updated and meaningful information, both in quantitative and qualitative terms.

**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.*

First of all, the use of credit ratings in the asset management industry is only one factor among others. At the latest, through the publication of the Directive 2013/14/EU of 21 May 2013 amending the UCITS Directive and the AIFM Directive in respect of over-reliance on credit ratings a legal system was put in place which is designed to avoid over-reliance on credit ratings by investment management companies. The implementation of these rules into the German Investment Act has been completed since December 2014. According to these requirements, the individual assessment of creditworthiness of financial instruments or entities is part of the overall risk-management process of the investment management company and serves as a principle against over-reliance on credit ratings. This process involves, in the light of the principle of proportionality, the assessment of any risk of each relevant assets invested by the investment funds (including the creditworthiness) and the establishment of an internal risk limit system for any relevant risk (including credit risk) on asset and fund level.

In practice, the risk management function is obliged to establish and implement quantitative or qualitative risk limits, or both, for each investment fund managed by the investment management company, taking into account all relevant risks. These include credit risks. Moreover, investment management companies may only deal with counterparties for which a counterparty limit system is in place (including in relation to the creditworthiness of the contracting party and the group membership). All transactions with a counterparty count in their full amount towards the (credit risk) limit on fund level or company level. Moreover, investment management companies are obliged to define limits for cash positions at banks in view of their creditworthiness and group membership.

The basis of the investment decision process is the risk limit system specified by the independent risk management function in accordance with the overall risk assessment. Therefore, investment decisions made by persons performing portfolio management do not solely or mechanically rely on credit ratings issued by credit rating agencies.

Otherwise, the work with ratings and the operational requirements deriving from the CRA III to reduce overreliance of ratings have increased. In particular, our members must demonstrate that these requirements are complied with.

Moreover, the main challenge is that professional investors such as banks or insurance undertakings still have to apply express requirements for use of ratings as a common independent measure of credit risk under the CRD IV and Solvency II regimes. As a result of the look-through approach regarding



fund's investments by such entities the investment process including investment guidelines of an investment management company must be designed in such a way that the asset manager is able to also fulfill these investor based requirements. However, all of these entities (banks, insurance undertakings and asset managers) have completely different business models which have an impact of the use of credit ratings and their own assessment processes of the creditworthiness of rated financial instruments or entities. Therefore, it should be kept in mind that the investment management company is only required to apply its own internal credit assessment per the applicable investment fund laws and regulations. The asset manager should not be required to recreate the internal credit assessment process of its investors.

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

The assessment of credit ratings' quality results mainly from two factors: Is the CRA registered in the ESMA's register and what is the expected rating quality level taking into account the published methodology. Moreover, the reputation of the CRA and its expertise in the specific field will also be taken into account.

**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.*

We kindly ask ESMA to avoid the wording "internal rating models". There is no general requirement for implementing "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 mechanically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument. The notion of "internal rating models" may not be compatible with the own credit risk assessment of any user of an external rating.

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

In view of the fact 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 in principle no need for alternative approaches. To the extent that existing regulation, e.g. ESMA money market fund guidelines, require the monitoring of ratings we would like to point out that our members can only get this 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 (defined as the rating and the corresponding identification of the rated object) are incurred.

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

In view of our members, external ratings are useful and reliable quantitative and qualitative indicators to assess the probability of default and/or expected loss of a rated investment. The benefit lies in independence and neutrality of the CRAs and in transparency of methodology and process. Our general



impression based on feedback of our members is that there is an increase of data size, rating coverage (such as ratings of assets issued by European enterprises or countries) and rating methods for special assets (such as medium-sized enterprises) since 2010. CRAs provide more information about any revision of credit ratings and methodology. They tend to inform on a more timely basis about their ratings.

However, we are not aware whether and to what extent the market criticism on the ratings and their quality is recognised by the CRAs. We therefore support ESMA's investigation in the way CRAs conduct surveillance of structured finance credit ratings<sup>2</sup>. In this context, we prefer as a first step a continuous monitoring and supervision based on the current CRA Regulation before stricter criteria are discussed. In particular, ESMA should monitor all registered CRAs as part of its on-going supervision that they properly incorporate the requirements and the objectives of the CRA Regulation into their working practices and remove any practices and procedures which conflict with these (such as the critical issues that ESMA identified in one or more CRAs as an outcome of the aforementioned report).

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

Investment management companies use credit-spreads, financial market information and reports of the entities that are assessed, market data on transactions and prices, stress tests and concentration-limits as well as other sources of information.

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

Our members are not reliant on unsolicited ratings in a specific manner. Therefore, we have no comment.

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

Please see our answer to question 5.

**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.*

Any credit rating payments currently are and should be in the future part of the relationship between the rated issuer and the CRA. However, in the area of money market funds there is an investor need for credit rating on such investment funds which is dealt with in the context of the Draft EU money market fund regulation.

Otherwise, our members are users and do not pay for credit ratings. Our members as users of credit ratings, however, pay CRAs to use ancillary services such as data feeds ("ratings lists ") and research.

**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.*

<sup>2</sup> [http://www.esma.europa.eu/system/files/esma-2014-1524\\_cra\\_public\\_report\\_on\\_sf\\_investigation.pdf](http://www.esma.europa.eu/system/files/esma-2014-1524_cra_public_report_on_sf_investigation.pdf)



As users of supervised credit rating agencies our members do not need to review this information in detail because from the viewpoint of a user it is more important that the ratings are reliable quantitative and qualitative indicators to assess the probability of default and/or expected loss of a rated investment. Only in this context, our members consider credit ratings as part of their due diligence and risk management process (please see our answer to questions 4 and 5).

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

Please see our answer to question 6.

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

Irrespective of any measures to amend the CRA Regulation, we prefer as a first step a strong monitoring and supervisory process based on the current CRA Regulation (please see our answer to question 8).

However, going forward, requirements affecting the rating process namely the requirement to change the lead rating analyst after a certain period should be critically reviewed. According to this requirement, we see a great danger that the quality of a rating suffers, in particular in the field there a special expertise of the rated product has been built over a long time. Another example is the sovereign rating area (Article 8a(3) of the CRA Regulation). The quality of the rating is negatively affected by the requirement to publish such rating only on specific dates.

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

**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.*

In principle, it should be sufficient to use a rating as an indicator of the creditworthiness of a rated asset. In this context, we greatly appreciate that the assessment of the credit quality of a money market instrument must not longer consider (as previously under the CESR's Money Market Fund Guidelines) each recognised credit rating agency that has rated the instrument. However, each manager of money market funds should be allowed to create its own credit assessment system with the understanding that the manager would have to provide the design and operational details of its system to allow competent authorities to evaluate the appropriateness of the system. In this context, it should be further clarified that an internal assessment of the credit quality of money market instruments does not necessary lead to a formal assignment of an internal "credit rating". The internal credit assessment of the "high quality" of investments must not lead to implementation of the same kind of research and governance processes which are implemented in a regulated credit rating agency. Moreover, manager of money market funds should only consider downgrades of such an agency if he has used the rating of the relevant agency within the internal credit assessment system.

**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.*





In principle, our members have no objections to use ratings issued by a small CRA. However, establishing rating experience needs time. As any other CRA also such CRA needs to demonstrate its experience in a particular sector as evidenced for example by historical default studies. A good example that there is a perceived quality difference between small and big CRAs is the proposed mapping on the allocation of credit assessments of ECAs to an objective scale of credit quality steps under the Solvency II and CRD IV regime.<sup>3</sup> This is highlighted by the fact that an AAA-rating of a big CRA is assigned to a better credit quality step than an AAA-rating of a small CRA.

**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 explain whether, and if so how, your approach to this issue has changed since 2010.*

In principle, our members would use also ratings issued by a CRA who has not previously rated a particular asset class because any new rating is a welcome additional input into the asset manager's internal credit assessment. This offers also the opportunity to compare the new rating with and thereby challenge long established ratings by entrenched providers.

**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.*

In principle, the requirements of the CRA Regulation to make information about the creditworthiness and performance of structured finance instruments available through a website are sufficient. However, investment management companies are obliged to demonstrate for each of their individual securitisation positions held by funds that they have a comprehensive and thorough understanding of those positions (cf. Article 53 of the Delegated Regulation (EU) No 231/2013 of 19 December 2012). We would welcome an additional statement by the responsible person for the reporting of the securitization to make also a formal declaration whether the instrument in question is a securitization under the AIFMD. It is up to the securitization provider to establish that the instrument offered is relevant for the AIFM target market or not. Finally, the securitization disclosure should also allow for a credit check on any entity debtor of a corporate loan taking part in the securitization portfolio. This basic credit quality score disclosure should be envisaged for all loans to entities which take part in a securitization portfolio. The identification of these entities should be based on the legal entity identifier as administered by the Global Legal Entity Identifier Foundation (GLEIF).

From the viewpoint of an investor of a structured finance instrument it is important to also to get a full picture of the structure, in particular to be able to understand the creditworthiness of all, including, the lower rated tranches. We therefore propose to review the disclosure requirements of issuers in relation to the ratings of lower rated tranches which may remain today unpublished.

We understand that the ESMA ratings database will be limited to published ratings which may be used for regulatory purposes. With regard to private ratings, this may create unintended consequences. For example, an issuer may be legally required not to publish ratings because of private placement rules

<sup>3</sup> <http://www.esma.europa.eu/-/eba-esma-and-eiopa-publish-addendum-to-joint-consultation-on-mapping-of-ecais>, <https://www.esma.europa.eu/documents/10180/1006707/JC+CP+2015+001+%28Joint+CP+on+draft+ITS+on+mapping+of+ECAs+under+SII%29.pdf>



prohibiting such disclosure. These private ratings therefore may not be used for purposes to assess the creditworthiness of an instrument, e.g. under bank capital requirements. The use of assigned ratings for regulatory purposes should not hinge on the fact of a publication of the rating, especially as the EU Capital Market Union project is calling for a modernized private placement regime including bonds.

Also in regard to the new Green Paper of the European Commission (building a capital markets union)<sup>4</sup>, minimum transparency standards on SME credit information would be helpful to render SME investments more attractive. In particular, there should be easy access to relevant data relating in particular to the solvency of an undertaking and to any material changes thereof. External ratings might be too expensive for SMEs and could again create the risk of over-reliance.

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

**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 in this field. In particular, they are not aware whether there are any quality losses of a rating due to the rotation provision to date. There may be the expectation in the market that the issuer ensures that at least one of the big three CRAs is always rating the particular securitization.

**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;*
- (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.*

Mandatory rotation should not be extended to other asset classes.

**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*

No comment.

**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).*

**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.*

<sup>4</sup> [http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper\\_en.pdf](http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf)





In principle, competition in general and within asset class distinguishes between different CRAs because they take different approaches to rate a financial instrument or issuer/counterparty. However, it is difficult to assess competition between CRAs in cases where completion is distorted by regulatory requirements such as to publish sovereign bond ratings only at specific intervals. Moreover, the issuer is mainly able to influence the competition as he selects one or more CRAs.

With regard to non-rating services, the license situation with respect to rating data feeds has got worse. There seems to be more alignment of different CRA licensing and charging practices for example, it is not possible to request data on an as needed basis with the big CRAs, i.e. on an ISIN by ISIN basis. Our members, however, need to work with tens of thousands of ratings on their own and their investors holdings on a daily basis. Many of our members need to check the validity of tens of thousands ratings per day which may be done only on an automated basis requiring ratings data feeds.

**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.*

In our view, there is no need for further regulatory measures to stimulate competition between CRAs. However, we expect that the ESMA operated European Ratings Database will improve transparency from end of 2016 onwards. It is of particular importance that the ERD caters to the needs of institutional investors which use ratings data (i.e. the rating plus the corresponding issue/issuer identification) in bulk. In this context ESMA needs to clarify that the public ratings database can be used also in case of “reuse” of ratings, e.g. in a situation where the outsourced asset manager needs to report the portfolio of the fund, including ratings of individual, to its institutional investors such as banks and insurance undertakings which are required by regulation to pay attention to ratings. It is not acceptable if such use of publicly available ratings data would require taking out data reporting licenses by the asset managers and their institutional investors with the CRAs. This would help to further cement the oligopoly of big rating agencies even more.

Competition may also be helped by a supervision. ESMA should continue to monitor all registered CRAs as part of its on-going supervision that they properly incorporate all the requirements and the objectives of the CRA Regulation into their working practices and remove any practices and procedures which conflict with these. There should be a particular focus on CRA ancillary services, especially rating data feeds, in order to discourage anti-competitive behaviour.

## Overview: Equity and fixed income funds investing in special countries regions

equity funds investing in special countries & regions, Australia  
equity funds investing in special countries & regions, China  
equity funds investing in special countries & regions, Germany  
equity funds investing in special countries & regions, emerging markets  
equity funds investing in special countries & regions, Euro countries  
equity funds investing in special countries & regions, Europe  
equity funds investing in special countries & regions, Far East including Japan  
equity funds investing in special countries & regions, Far East excluding Japan  
equity funds investing in special countries & regions, France  
equity funds investing in special countries & regions, Great Britain  
equity funds investing in special countries & regions, Iberia  
equity funds investing in special countries & regions, India  
equity funds investing in special countries & regions, Italy  
equity funds investing in special countries & regions, Japan  
equity funds investing in special countries & regions, Latin America  
equity funds investing in special countries & regions, Netherlands  
equity funds investing in special countries & regions, North America  
equity funds investing in special countries & regions, Austria  
equity funds investing in special countries & regions, Eastern Europe  
equity funds investing in special countries & regions, Switzerland  
equity funds investing in special countries & regions, Scandinavia  
equity funds investing in special countries & regions, other than categorized herein  
equity funds investing globally

fixed income funds investing mainly in Euro; middle-term bond funds

fixed income funds investing globally; middle-term bond funds

fixed income funds investing globally, specific currencies, British Pound  
fixed income funds investing globally, specific currencies, Danish Kroner  
fixed income funds investing in currencies of emerging markets; middle- and long-term bond funds  
fixed income funds investing mainly in European currencies; middle- and long-term bond funds  
fixed income funds investing globally, specific currencies; Norwegian Kroner  
fixed income funds investing globally, specific currencies; US-Dollar  
fixed income funds investing globally, specific currencies, Japanese Yen  
fixed income funds investing globally, specific currencies; Far East including Japanese Yen  
fixed income funds investing globally, specific currencies; Far East excluding Japanese Yen  
fixed income funds investing globally, specific currencies other than categorized herein