Europe Economics

Credit Rating Agency market study: Questionnaire for Investors

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1. Introduction

Europe Economics (www.europe-economics.com) is undertaking research into the credit rating agency (CRA) market for DG FISMA (Financial Stability, Financial Services and Capital Markets Union) of the European Commission. This study will contribute to DG FISMA's assessment of the latest Credit Ratings Agency Regulation ("CRA 3 Regulation").[1]

Europe Economics is seeking important input from market participants regarding their views on the implementation and impact of these provisions, and information about the credit rating market more generally. This survey differs from ESMA's call for evidence issued in 2014 in that it has been developed as input to a wider analytical framework for understanding the credit rating market and assessing the impacts of the Regulations. A letter of support for this survey from DG FISMA can be viewed here.[2]

All responses to the survey will remain **confidential** to Europe Economics. Any information from the survey used in our reports will be aggregated, and nothing will be directly attributed to individuals or firms in our published report.

Please complete the following questions and return the survey to Deborah Drury: CRAstudy@europe-economics.com by **12 October 2015**. Deborah will also answer any queries you may have regarding the questionnaire.

[1] Regulation (EU) No 462/20913 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit ratings agencies, OJL 146, 31.5.2013.

[2] http://www.europe-economics.com/attachments/support_letter_europe_economics_1437402640.pdf

2. Background questions

1. Please state your name, role and contact details, and the name of your firm and main activities undertaken:

Your name	*Peggy Steffen*
Email and telephone	*peggy.steffen@bvi.de* *+4969154090257*
Role	*Vice president, responsible for legal affairs*
Name of firm	*BVI Bundesverband Investment und Asset Management eV*
Main activities	BVI represents the interests of the German investment fund and asset management industry. Its 91 members manage assets of approximately of EUR 2.6 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.

1. Please state the value of your assets under management for the last financial year.

Our 91 members manage assets of approximately of EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds.

2. Please state the product type in which you have the most direct experience as an investor:

Products	Yes / No	Date entered the market
Corporate bonds	*Yes*	*More than 20 years*
Sovereign / public bonds	*Yes*	*More than 20 years*
Structured finance instruments (general)	*Yes*	*More than 10 years*
Re-securitised structured finance instruments	*Yes*	*More than 5 years*
Other, *CLNs, Convertibles, CoCos*	*Yes*	*More than 10 years*

For the remainder of the questionnaire, please answer only with respect to these product(s).

3. Competition and concentration

The objective of the CRA 3 Regulation here is to promote competition and reduce concentration in the credit rating market, which is currently dominated by three large global CRAs. This is done by reducing search costs for investors and facilitating comparisons between all ratings for the same instrument (Article 11a), and encouraging the use of multiple CRAs and of smaller CRAs.

The relevant provisions of the CRA 3 Regulation are:

Articles 8c: an issuer intending to solicit credit ratings for a structured finance instrument (SFI) must appoint at least two credit rating agencies to provide ratings, independently of each other.

Article 8d: where an issuer intends to appoint at least two credit rating agencies for the rating of the same issuance or entity, the issuer shall consider appointing at least one credit rating agency with no more than 10 per cent of the total market share, or document the decision not to do so (i.e. 'comply or explain').

Article 11a: CRAs must submit relevant credit rating information when issuing ratings or outlooks to a central European Rating Platform to be operated by ESMA. This will allow investors to consult and easily compare all available credit ratings for all rated instruments.

The CRA 3 Regulation also applies specific exemptions to the general requirements to alleviate the burden of compliance on smaller CRAs.

3. Please list the credit rating agencies recognised by your institution.

Our members use ratings issued by all credit rating agencies which are registered by ESMA. However, the focus is on the big credit rating agencies such as S&P, Moody's and Fitch.

4. What credit analysis does your institution typically carry out?

	Yes / No
a. Ratings from CRAs	*Yes*
b. Rating with quick scan of key financials	*Yes*
c. Ratings combined with other proprietary measures such as Moody's EDFs, credit metrics etc.	*Yes*
d. In-house advanced models, if so, please specify in the next question	*Yes*

5. If you answered 'Yes' to (d) above, please specify the types of models you use:

	Yes / No
Logit/regression models	*No*
Neural networks	*No*
Price/yield/CDS-spread-based measures	*Yes*
Support vector machines	*No*
Structural model based measures (a la KMV)	*Yes*
Other, ***please list***	*No*

6. If you use internal or external advanced models, how do these on average compare to CRA ratings for corporate bonds and structured finance products?

Corporate bonds	*Choose your answer*
Structured finance products	*Choose your answer*

7. When considering the value of a rating from a CRA, what factors do you consider? Please answer with respect to instrument(s) in which you have direct experience (as stated in Q2.2). **Please score the following from 1 to 5, with 1 = critically important, down to 5 = unimportant.**

Factor	**Corporate bonds**	**Structured finance products**
Analytical methodologies	*2*	*2*
Recognition of name	*4*	*4*
Size / market share	*4*	*4*
Reputation for quality	*2*	*2*

The historical performance of the CRA's ratings	*2*	*2*
Own analysis of CRA's ratings quality, e.g. analysis of CEREP data	*4*	*4*
Compliance with regulatory requirements	*1 - Critically important*	*3*
Other, ***please list***	*1 - Critically important*	*3*

8. Have you noticed an increase in transparency and disclosure of CRA methodologies since 2010?

☐ Yes – significant increase.

☒ Yes – mild increase.

☐ No increase.

9. If yes, how has this impacted upon how you assess the quality of ratings from CRAs?

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. In this context, we prefer as a first step a continu-ous monitoring and supervision based on the current CRA Regulation before stricter criteria are dis-cussed. 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 is-sues that ESMA identified in one or more CRAs as an outcome of the aforementioned report).

10. When considering multiple ratings of an instrument, and where ratings are different:

    a. How do you decide which rating to place the most weight on?

In principle, it should be sufficient to use a rating as an indicator of the creditworthiness of a rated asset. However, in principle, our members weight all ratings equally building an average in case of split-ratings. Moreover, if insurance undertakings are invested in funds, our members are oriented on the German insurance supervisor - BaFin's anouncements on the use of external ratings and on making own credit risk assessments for insurance undertakings (http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Auslegungsentscheidung/ae_external_ratings_va_en.html). According to this note, the following applies: If an external rating exists, an additional quantitative assessment may result in the own credit assessment yielding a better result than the external rating. If there are two different external ratings and an insurance undertaking's own credit risk assessment yields a better result than the lower of the two external ratings, the insurance undertaking must make an additional quantitative assessment. If there are three external ratings and an insurance undertaking's own assessment yields a better result than the second best of the external ratings, the insurance undertaking must also make an additional quantitative assessment. However, we want to stress that the investment management company is only required to apply its own internal assessment per the applicable investment fund laws and regulations. The asset manager is not (and should not be) required to recreate the internal credit assessment process of its institutional investors because 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. Finally, it should be kept in mind that Article 4 of the Delegated Regulation (EU) 2015/35 supplementing the Solvency II Directive requires another regime in dealing with split-ratings to determine the capital requirements of insurance undertakings.

b. Do you place more weight on ratings from larger CRAs?

Yes. In our view, there is a perceived quality difference between small and big CRAs. A good example is the proposed mapping on the allocation of credit assessments of ECAIs to an objective scale of credit quality steps under the Solvency II and CRD IV regime. 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.

11. Have you noticed any of the following changes in relation to structured finance products since 2013?

Please indicate whether each variable has increased / remained the same / decreased.

Variable	Change since 2013
Number of structured finance products marketed	*Decreased*
Number of CRAs providing ratings for structured finance products	*Increased*
Average level of CRA ratings	*Remained the same*
Other changes, *Reduction of product complexity*	*Decreased*

4. Rotation

The objective of the CRA 3 Regulation here is to further promote competition in the CRA market by encouraging other CRAs to rate re-securitisation instruments (for this reason mandatory rotation will cease to apply where at least four CRAs each rate more than 10 per cent of the total number of outstanding re-securitisations). The objective is also to reduce conflicts of interest by reducing the incentives on CRAs to produce inaccurate but favourable ratings in order to retain issuers' custom for long periods of time.

The relevant provision of the CRA 3 Regulation is:

Article 6b: An outgoing CRA would not be allowed to rate re-securitised products with underlying assets from the same originator for a period equal to the duration of the expired contract, though not exceeding four years.

1. In your view, how will (has) the Rotation provision impact the ratings of re-securitised structured finance products? **Please score each of the impacts between 1 = extremely likely and 5 = very unlikely, and provide reasons for your answers.**

Impact	Likelihood score	Reasons
Increases the number of CRAs rating these instruments, in particular CRAs with less than 10% of market share	*4*	*Small market participants are often not able to sustain a suitable coverage.*
Reduces the ability of CRAs to accumulate knowledge about the issuer (i.e. negatively impacts ratings quality)	*2*	*Forced analyst rotation reduces knowledge base.*
Reduces conflicts of interest stemming from long-term relationships between issuers and CRAs	*2*	*For smaller market participants the conflict of interest might even be higher.*
Increases the costs to issuers of ratings	*2*	*Because of the loss of experience.*
Increases volatility of ratings	*2*	*Volatility between analysts within one CRA. Volatility between CRA's.*
Other, ***please list***	*Choose your score*	*Type your reasons here*

2. Are there any measures / adaptations that you would consider useful to improve the effectiveness of the current rotation system? Please provide reasons for your answer.

   ☐ Yes, there are. ***Type the measures / adaptations and you reasons here.***

   ☒ No, I cannot think of any measures / adaptations.

3. Should the Rotation requirement be extended to other instruments? If yes, please explain to which instruments this obligation should be extended, and why.

   ☐ Yes, is should be extended to ***type the instruments and your explanation here.***

   ☒ No, it should not.

5. Conflicts of interest

The objective of the CRA 3 Regulation here is to reduce the conflicts of interest within CRAs associated with the 'issuer pays' model of remuneration, certain ownership structures, and incentives on employees, which may result in inaccurate ratings.

The relevant provisions of the CRA 3 Regulation are:

Article 6: governance and internal procedures CRAs are to undertake to ensure that the issuing of a credit rating or a rating outlook is not affected by any existing or potential conflicts of interest. This includes prohibiting CRAs from providing ratings of any person or any financial instrument issued by a person that owns shares of the CRA, or directly or indirectly controls the CRA.

Article 6a: Shareholders who hold at least 5 per cent of capital or voting rights in an agency are prohibited to hold more than 5 per cent of capital of voting rights in another CRA.

Article 7: requirements for CRAs concerning their employees, in terms of the nature of and activities performed by the employees, and CRAs' performance evaluations. E.g.: a rotation mechanism for rating analysts and people approving ratings.

1. Do you conduct any due diligence on CRA's internal governance procedures? If yes, please explain what you do. If no, please explain your reasons.

   ☐ Yes. ***Type the description of due diligence here***.

☒ No. *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 infor-mation, both in quantitative and qualitative terms.*

2. Do you think Article 6 (the prevention of CRAs rating issuers with a shareholding) has improved the independence and quality of the ratings processes of CRAs? **Please score your answer,**

with 1 = Yes, to a large extent to 5 = no change (if you believe it has had a negative effect, please write that in).

Please provide a brief explanation for your score, indicating if your view differs by type of financial instrument (i.e. corporate bonds, sovereign or public bonds, structured finance products).

Score	Explanation
4	*We do not believe that there was a large influence before.*

3. Do you think Article 6a (limitations in shareholdings across multiple CRAs) has improved the independence and quality of ratings processes? **Please score your answer as 5 = Yes, to a large extent through to 1 = No change (if you believe it has had a negative effect, please write that in).**

   Please provide a brief explanation for your score, indicating if your view differs by type of financial instrument (i.e. corporate bonds, sovereign or public bonds, structured finance products).

Score	Explanation
4	*We do not believe that there was a large influence before.*

4. Do you think Article 7 (rotation mechanism for ratings analysts and rules around links between remuneration and payment from issuers) has affected the quality and independence of ratings processes? **Please score your answer as 5 = Yes, to a large extent through to 1 = No change (if you believe it has had a negative effect, please write that in).**

   Please provide a brief explanation for your score, indicating if your view differs by type of financial instrument.

Score	Explanation
Negative effect	*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. 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.*

6. Disclosure on structured finance products

The objective of the CRA 3 Regulation here is to improve the ability of investors to make their own informed assessment of the creditworthiness of structured finance instruments by providing them with sufficient information the quality of the underlying assets of these instruments.

The relevant provision of the CRA Regulation is:

Article 8b: the issuer, originator and sponsor of structured finance instruments who are established in the EU shall jointly publish information on these instruments and the performance of their underlying assets.

1. Please indicate which of the following types of information you consider when deciding whether to invest in an instrument. **Please score these in terms of importance, with 1 = critically important and 5 = unimportant.**

Type of information	Importance score
External credit ratings from CRAs	*3*
Internal rating models/ internal expertise	*1 - critically important*
Information published by issuers	*2*
Other market information	*2*
Other, ***please list***	*Choose your score*

2. If the types of information you consider, and their relative importance, differs for **structured finance instruments**, please provide this information in the table below.

Type of information for structured finance instruments	Importance score
External credit ratings from CRAs	*3*
Internal ratings models/ internal expertise	*1 - critically important*
Information published by issuers	*1 - critically important*
Other market information	*2*
Other, ***please list***	*Choose your score*

3. If you are using advance credit analysis models as per question 2.2 (d) do you think that the increased disclosure of information on structured finance products would help to calibrate these models?

☐ Yes, to a large extent.

☒ Yes, to a large extent.

☐ No.

☐ Have not yet had a change to consider this type of information

☐ Do not know.

4. What is the approximate number (or proportion of the market) of structured finance instruments traded in the EU where the issuer, originator, sponsor are all based outside the EU? Please answer with respect to:

The past financial year	*Not applicable*
The previous five years	*Not applicable*

5. In your view, how effective will the disclosure provision be in enhancing your ability to make your own informed assessment of the creditworthiness of these instruments? **Please score your response from 1 to 5, with 1 = provision will be extremely effective and 5 = provision will not be effective.**

Please give reasons for why you think this provision either will or will not enhance your assessment (for example, the nature of structured finance instruments; any underlying features of the credit ratings market; lack of sufficient internal resources/expertise, unintended consequences of the provision etc.).

Score	Explanation
2	*Detailed structured finance pool and cashflow information is important.*

6. If you consider that your ability to make your own assessments of the creditworthiness of instruments **would increase**, what impacts would this have? **Please score the impacts from 1 = very high impact to 5 = no/negligible impact. Please provide reasons for your answers.**

Impact	Score	Reasons
Reduce our reliance on external ratings from CRAs	*4*	*Our members do not rely solely and automatically on external ratings. The use of credit ratings is only one factor of many in the credit assessement 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 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.*
Enable us to better assess the quality of CRAs' ratings	*4*	*Cf. above*
Put us at an advantage over other investors	*Choose your score*	*Type your reasons here*
Other impacts, ***please list***	*Choose your score*	*Type your reasons here*

7. Would you welcome the extension of the disclosure requirement in Article 8b to other instruments? If yes, please explain to which products this obligation should be extended, and why.

☐ Yes, I would welcome extension to ***type the instruments and your explanation***.

☒ No, I would not welcome extensions.

7. Remuneration models

1. Please indicate which of the following ways of paying for ratings is most common for you, estimating the approximate share of each way.

Remuneration models	**Estimate of share**		
	Corporate bonds	**Sovereign bonds**	**Structured finance instruments**
Issuer pays	*95 %*	*95 %*	*95 %*
Investor pays	*Type share here* %	*Type share here* %	*Type share here* %
Combined (issuer and investors pay)	*Type share here* %	*Type share here* %	*Type share here* %
Investor-produced ratings	*Type share here* %	*Type share here* %	*Type share here* %
Unsolicited ratings	*Type share here* %	*Type share here* %	*Type share here* %
Philanthropic (not for profit) rating initiatives	*Type share here* %	*Type share here* %	*Type share here* %
Others, ***please list***	*Type share here* %	*Type share here* %	*Type share here* %

2. If you use or subscribe to investor-paid, investor produced or philanthropic ratings, please explain why.

Type your answer here.

3. For those other remuneration models which are the most commonly used, please provide reasons for this in your view.

Issuer pays is most convenient for investors.

4. For those remuneration models which are the least commonly used, please provide reasons for this in your view.

Investor paid is too expensive and inefficient.

5. Has there been a change in the type and share of remuneration models used since 2010? Please explain.

   ☐ Yes, there has. ***Type your explanation here***.

   ☒ No, there has not. ***Type your explanation here***.

6. Do you place a different value on ratings from different remuneration models? Please explain.

   ☐ Yes. ***Type your explanation here***.

   ☒ No. ***Type your explanation here***.

7. Under what circumstances would you be willing to pay for ratings?

Type your answer here.

8. What changes (if any) would be desirable in your opinion in the remuneration models of credit rating agencies to further reduce the risk of conflict of interests. Please also describe the difficulties you see in the implementation of the changes you suggest.

Desirable changes	Anticipated difficulties
Type your answer here.	*Type your answer here.*
Type your answer here.	*Type your answer here.*
Type your answer here.	*Type your answer here.*

8. Further contribution

If you have any further comments in relation to any of the topics discussed, please include them here.

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.

Europe Economics may wish to contact you to explore some of your answers. Should you **not** be willing to be contacted please tick below.

I do not wish to be contacted by Europe Economics	☐

Europe Economics may wish to notify DG FISMA of the names of the organisations that have responded to the survey (but not share the responses). If you do **not** wish DG FISMA to know the identity of your organisation, please tick below.

I do not wish DG FISMA to know the identity of my organisation.	☐

Thank you very much for your input to this study.