POSITION PAPER

ESBG response to the public consultation on Credit Rating Agencies

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The European Savings Banks Group (ESBG) appreciates the opportunity to comment on the public consultation on Credit Rating Agencies, issued by the European Commission in November 2010.

General comments

Credit Rating Agencies (CRAs) play a crucial role in the financial markets, and confidence of market participants in the quality and reliability of ratings is fundamental for the functioning of the markets. Weaknesses, in particular in relation to the rating of structured financial products and the evaluation of their systemic risks, have contributed to the loss of confidence in this area. The 2009 Regulation (EC 1060/2009) has been created to remedy these weaknesses and to construct a solid basis for the registration and supervision of CRAs and to simultaneously improve CRA's rules of conduct, quality of ratings and transparency of ratings and rating processes. ESBG welcomes again the policy measures taken in 2009. The 2010 revision will adapt the Regulation to ESMA's new role (its exclusive supervisory powers for CRAs) and strengthened certain provisions of the Regulation, in particular, in relation to transparency.

The Commission consultation paper addresses aspects which in ESBG's view indeed deserve additional attention. As such, ESBG underlines the need for more transparency as regards the methodology and construction of credit ratings in all asset categories. However, ESBG is more hesitant to support the additional obligations outlined by the Commission for the users of external ratings, i.e. financial institutions which draw on CRA ratings for their risk management and determination of capital requirements. ESBG also does not believe that financial institutions should be required to construct their own internal ratings on sovereign debt. On the other hand, particular attention should be devoted to increasing competition in the CRA sector. ESBG provides below detailed comments to the questions addressed in the consultation paper and stands ready to further contribute to the reflections by the European Commission, in preparation of its assessment by end 2012.

Specific comments to the questions contained in the consultation paper

(1) Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?

In ESBG's view, the use of standardised approaches based on external ratings should not depend on size, sophistication and/or complexity of a financial institution. We would like to emphasise that generally, institutions base their choice of approach on a range of different criteria. Important factors are the institution's strategic orientation and risk profile, but also capital resources, different aspects of implementation of internal models and internal resources.

ESBG also would like to point out that there are already significant incentives for institutions to use internal models. For once, there is market pressure, as investors and CRAs alike already now expect financial institutions of a certain size to have highly complex internal rating models in place. In addition, given that the standard model based on external ratings is usually more demanding in

capital, large, medium and even smaller sized institutions which have the possibility to develop internal models will always have an incentive to do so in order to save capital.
On this basis, ESBG does not consider it appropriate to limit the use of the standardised approach to certain categories of financial institutions.

(2) How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?

In ESBG's view, the credibility of internal ratings for standard portfolios should not be questioned as such, also as internal rating systems are regularly assessed and validated. In addition ESBG would like to point out that also institutions, which do not hold an IRBA authorisation but draw on internal models in context of their lending decisions, still have a strong interest in using validated models.

Furthermore, ESBG would like to underline that according to our members' experience, as concerns the rating of small and medium sized enterprises (SMEs) as well as individuals, internal models have worked quite well. As concerns the rating of larger corporates, other financial institutions or sovereigns, ESBG observes that internal ratings have generally not performed worse than external ratings, also as internal models tend to emulate rating agencies' models.

As regards possible improvements to the reliability of internal models/ratings, ESBG sees room for drawing on more information, including or increasing the weight of qualitative aspects and internal analysts' opinions.

(3) Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?

ESBG does not take the view that a requirement to use at least two external ratings would be a real solution to the problems identified.

While ESBG admits that in theory, on the downside the accuracy in relation to regulatory capital calculation could be improved if in this process the worse rating of the two was selected, we are not convinced that this would work in practice. In particular, ESBG would like to highlight that the ratings of the three large CRAs are generally very similar, so that the use of multiple ratings does not necessarily bring any added value to investors, who, in any case, increasingly base their decisions on their own analysis and judgement. In addition ESBG are apprehensive that a regulatory requirement to use two ratings would ultimately only strengthen the already existing oligopoly of the three large rating agencies.

(4) What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?

Firstly, ESBG would like to stress that the use of ratings for regulatory purposes should not be eliminated.

Secondly, as regards alternative measures for credit risk, ESBG sees some room to complement ratings with inputs such as CDS spreads, bond prices, and stock volatility to be included in the internal analysis. However, ESBG believes that such complementary measures for credit risk should not become subjected to the supervisory process. This is to a large extent due to the 'cons' of such market based risk measures, which include a considerable degree of pro-cyclicality and the incorporation of market expectations, which, however, often are not met. Furthermore, ESBG does not see an effective way of mitigating such pro-cyclicality.

Specifically with view to the use of CDS spreads we would like to remark, that, although they may precede the respective down-grading by CRAs, there is a high degree of market concentration, as CDS are generally traded amongst a small number of large banks only. As a result, from a systemic perspective, the trade with CDS can be affected by developments surrounding a large market participant, which would also distort the information content of the CDS as regards the underlying credit risk.

In more general terms, we find that developments on the CDS market do not always directly reflect the underlying credit default risk or changes in the quality of the debtor. Furthermore, CDS products are often highly complex and their market is wrought with uncertainties. Both complexities and uncertainties should thus not be 'imported' into Pillar 1.

(5) Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed? To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?

ESBG considers that for securitisations positions a reliable assessment of capital requirements is important and that an investor should have information on the quality and characteristics of the underlying assets.

Yet ESBG does not think it advisable to require that all securitisations positions be internally rated, in particular as this would further decrease the investor base for securitisation products. Furthermore ESBG finds that Article 122a of the Credit Requirements Directive already makes substantial provisions concerning investors' ability to assess the risk of their securitisations positions.

(6) Can the existing "supervisory formula" based approach in the Capital Requirements Directive be considered to be sufficiently risk sensitive to become the standard for all securitisation capital requirements? If not, how could its risk sensitivity be improved without placing reliance on institutions' internal estimates other than default probability and loss for the underlying exposures? In the insurance sector, how do you assess the approach to credit risk for structured exposures used in QIS 5?

As regards the application of the 'supervisory formula' to securitisation positions, ESBG sees a number of practical problems for investors. In particular, the information required for an internal ratings based approach may actually not be available for each borrower. It also presumes that the investor has at his disposal the necessary internal ratings procedures. Furthermore, it could mean that investors would have to construct a huge number of additional internal ratings. This would be very cost intensive, while, especially in the case of homogeneous granular portfolios the added value in terms of risk assessment may be very limited as compared to the current procedures. Thus,

ESBG advocate, that, also in order to not further reduce the investor basis, there should be room for alternative procedures.

Furthermore, ESBG is of the opinion that risk sensitivity could be improved through the evaluation of the concentration of underlying assets – similar to the new requirements for large exposures (applicable as of 1 January 2011) – taking into account quality, maturity etc.

(7) Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?

ESBG would like to stress that financial institutions should indeed take a critical and circumspective view on external ratings. Here, one should take note that banks using the standardised approach already use their own judgement and due diligence in order to not blindly rely on external ratings. Nevertheless, the due diligence requirement should not cumulate in an obligation to construct a 'shadow rating'. Also, imposing the need for a close assessment of external rating and risk weight for all assets is not in line with the proportionality principle in Pillar 2.

All in all, one should not forget that external ratings also facilitate efficiency on capital markets, especially since it cannot be expected that each institution can conduct research on each and every debt instrument on the market. Here ESBG also points out that rating agencies generally still have superior and internal information on their customers, and that the main criticism concerning the quality of ratings applies to specialised segments, such as securitizations, due to the inadequate way in which such ratings were generally constructed in the past and leading up to the crisis.

(8) What information should be disclosed to supervisors in order to enable them to monitor the internal risk management processes of firms with particular focus on the use of external credit ratings in these processes?

ESBG considers that under the current Pillar 2 framework an institution should ensure that, when drawing on an external rating, it has appropriate methods and processes in place to derive an own view on the risk of default. The respective processes currently in place already mean that own insights and information are incorporated into lending decisions. ESBG thus takes the view that an additional disclosure of information to supervisors in this regard is not necessary.

(9) To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in their investment policies, risk management processes and in investment mandates?

ESBG notes that the use of credit risk models for risk management is nowadays general practice in credit institutions, particularly those which are IRB (internal rating based) banks. The Boards of Directors and other governing bodies are usually informed about the essential changes in rating methodologies and have a comprehensive understanding regarding the structure of the credit rating system and its application. Substantial deviations from the established rating methods are usually approved by the management. Additional obligations for the top management are in our view unnecessary.

(10) What further measures, in addition to the disclosure proposals included in Articles 8a and 8b of the proposal amending the current CRA Regulation could be envisaged?

In this regard ESBG sees some room for greater transparency (particularly concerning issuers in the case of structured products). Yet, the scope should remain appropriate; for instance an obligation to record telephone conversations would go too far.

(11) Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?

ESBG shares the assessment that sovereign debt ratings are primarily based on publicly available data and that in this context rating agencies do not have any advanced or 'insider' knowledge. However, ESBG disputes, that, even on the basis of this publicly available data, all financial firms are in a position to internally and comprehensively assess the credit risk of sovereign debt. After all, such an assessment requires substantial resources as well as specialised analysts and tools, i.e. a high degree of sophistication and ability to shoulder considerable expenses. Therefore credit rating agencies still have a comparative advantage.

(12) Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?

ESBG welcomes the idea of a flexibility clause. Such a clause should enable investment managers to distinct themselves from competitors and to decide on a case-by-case basis and depending on the investment portfolio whether they temporarily deviate from external rating thresholds. Furthermore such a clause could help to reduce risks of identical behaviour at the same point in time.

(13) Should investment managers be obliged to introduce measures to ensure that the proportion of portfolios that is solely reliant on external credit ratings is limited? If yes, what limitations could be considered appropriate? Should such limitation be phased in over time?

For the time being this option seems not viable.

(14) What alternative measures of credit risk could be used to define the minimum standard of credit quality for a portfolio? Are rolling averages of bond prices/CDS spreads a suitable risk measure for this purpose?

Alternative measures could include the grade of sophistication of the asset, its liquidity, and, depending on the portfolio, CDS spreads, bond prices etc. However, these alternative measures on their own could not be considered as a substitute for a rating. Beyond that, ESBG underlines that rolling averages are no suitable risk measures.

(15) What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates?

In ESBG's view external credit ratings should be complemented by other information sources. ESBG refers to its answer to question 14 with respect to alternative measures, insisting again that these are no substitute for a rating. In addition to these measures the creation and importance of internal analyst opinions should be strengthened.

(16) What is your opinion regarding the ideas outlined above? How can the transparency and monitoring of sovereign debt ratings be improved?

ESBG supports the idea that the full report underlying a sovereign debt rating should be disclosed. This, however, should also imply similar disclosure requirements concerning the ratings of corporate and financial instruments, in order to ensure market consistency and comparability.

In addition ESBG finds that for sovereign ratings, supervisors should be in the position to establish greater control on CRAs' methodologies, also with view to sudden changes in ratings.

(17) Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?

Here ESBG thinks it particularly important to focus on the effect of ratings in exceptional circumstances. Especially in crisis situations, in order to not counter-act support and stabilisation measures, it should be possible to 'freeze' a sovereign debt rating for an appropriate time horizon. Nevertheless, CRAs should remain obliged to continue their observation and information function vis-à-vis the market. After this 'freeze-period' has expired, the rating should be adjusted gradually only in order to avoid renewed instability.

(18) Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?

Among the advantages, ESBG counts the possibility for countries to resolve errors and to anticipate market movements. The disadvantages include the risk of increased speculative movements.

Market abuse could be mitigated by increasing the confidentiality requirements concerning staff immediately involved both in the country and in the respective CRAs.

(19) What is your opinion on the need to introduce one or more the proposed measures?

ESBG welcomes the proposals on the disclosure of methodology, models and underlying assumptions for each rating. Yet, ESBG would like to emphasise that the disclosure of such information will not necessarily enable the investor to conduct his own rating.

(20) More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?

ESBG is not confident that the proposal to publish sovereign debt ratings only after the close of business on EU trading venues will prove useful. For once, the trading in sovereign debt is a global activity, and other exchanges are still open after the closing of the European trading venues. Thus, markets will react in any case and volatility will not be reduced. In addition, markets generally anticipate changes in ratings (whether positive or negative). Secondly, ESBG does not find that a special treatment of sovereign debt ratings as compared to other ratings is appropriate, but ESBG finds that such a rule would not be objectionable if applied to the publication of all ratings.

(21) Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?

ESBG sees room for such a commitment to have the desired effect.

(22) What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

ESBG would recommend exploring whether CRAs could be obliged to publish an additional 'stand-alone rating' which excludes possible support measures from third parties. We do not believe that this would produce an additional cost, but we find that this could increase the disciplining effect of capital markets on national fiscal and budgetary decisions.

ESBG also would welcome a better explanation of rating methodologies (including the range of variables and ratios used) as well as an identification of critical inputs, in particular those which could trigger a rating action.

(23) How could new players be encouraged to enter the credit rating agency sector?

ESBG supports the aim of enhancing competition in the Credit Rating Industry. In general, competition has dynamic functions (e.g. innovation), and, in particular in the context of ratings, should lead to behaviour patterns in the markets that can give investors a secure foundation for their decision. This means that competition should be intrinsically linked with enhanced transparency, comparability and reliability of ratings.

While ESBG will comment below on the different concrete proposals made by the European Commission, it here gives some general indications: the creation of specialised CRAs should be facilitated, e.g. by giving incentives to certain companies with proven experience in specific sectors; furthermore the offer of trainings for CRA professional should be increased.

(24) Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions? If yes, which asset classes (corporate, sovereign, structured finance instruments etc) could be considered?

In response to questions 24 and 25, ESBG recognises that the ECSB has developed competences, i.a. through the process of assessing commercial loans; however, a critical reflection of a possible role of

the ECB needs to take place. In this context, ESBG refers also to its position paper of November 2010 regarding the ECAI recognition process.

(25) Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?

Please see above.

(26) Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level? How could such agencies be structured and funded and what entities and products should they rate? What are the potential advantages and disadvantages of this approach?

As outlined in the answer to question 23, the creation of specialised CRAs should be facilitated. This could be done at national level.

New CRAs could e.g. rate SMEs and large corporate not yet rated by existing CRAs.

The creation of new CRA would have the advantage of increasing the proximity and knowledge of the concerned industry. Based on a good and clear legal framework such CRA would start their work, with the challenge to position themselves as quickly as possible as professional and competent players, building their good reputation.

(27) Is there a need to create a new independent European Credit Rating Agency? If so, how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit rating agency? What are the potential advantages and disadvantages of this approach?

ESBG welcomes the idea of the creation of a new European Credit Rating Agency. It is crucial to ensure the independency of this body and thereby to avoid conflicts of interests; financing arrangement need to be developed in a manner which respects these principles, i.e. funding would have to be provided by third parties.

The European Credit Rating Agency should be able to rate sovereign debt as well as corporate and structured finance products. The use of its ratings as a second external rating should not be obligatory; rather ESBG expects that this Agency could gain good reputation and be quickly accepted by markets as an alternative to purely commercial external ratings.

The potential advantage of a European Credit Rating Agency is the establishment of an additional source of information, in particular for helping investors using the standardised approach to take their investment decision. The disadvantages lie in the first step in the high costs (especially up-front). Later in the process, in "worst" case in which reliability of the Agency's ratings could not be ensured, such an Agency could evolve to a generator of reputational risk for the EU.

(28) Is further intervention needed to lower barriers to entry or expansion in the credit rating agency sector in general or as regards specific segments of the credit ratings business? What actions could be envisaged at EU and at Member State level?

ESBG confirms that further intervention is needed to lower barriers to entry or expansion in the CRA sector. The procedures contained in the Regulation, in particular in relation to registration, could be explained in more detail (e.g. by a guidance or a Q&A tool).

(29) Would the creation of a European Network of Small and Medium Sized Credit Rating Agencies help increase competition in the credit rating agency sector? What are the potential advantages and disadvantages of this approach?

In principle ESBG supports the idea of a creation of a European Network of Small and Medium Sized CRAs, noting that the independency of this network needs to be ensured. This is challenging, as even the small credit rating agencies newly created by a number of financial services providers could be caught in conflicts of interest. Nevertheless it remains worth to undertake efforts in this direction, because such a network would help to increase competition in the sector, although this is not necessarily applicable to all cases (see niche CRAs). Furthermore the network would need to win the recognition of supervisors and the other market players by creating a new "brand" as compared to the big three CRAs.

(30) Do you consider that there are any further measures that could be adopted to enhance competition in the rating business?

The EU legislation regulates a sector which had not been directly supervised in the past. It is important that ESMA builds up efficient monitoring and high-quality supervision. In addition, CRAs should be liable for errors committed (please see also answer to question 31).

(31) Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?

The revised EU Regulation is expected to attribute ESMA sanctioning powers (e.g. withdrawal of registration). Beyond that aspect, the concept of civil liability for CRAs appears as a useful tool to enhance integrity of the business. Taking into account different national traditions and practices with respect to civil law, it seems adequate to focus on a strengthening of Recital 69, included in Regulation 1060/2009 and thereby reinforce national responsibility for enforcing civil liability.

(32) If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?

CRAs should not only be liable for gross negligence and intent, but also for intentional or negligent infringements of the provisions of the Regulation. Furthermore they should be liable when ratings have demonstrated erroneous because of their severe review (more than nine notches) or when they disappear immediately after issuance.

(33) Should such a potential liability regime cover solicited as well as unsolicited ratings?

ESBG agrees that a liability regime should cover solicited as well as unsolicited ratings.

(34) Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?

ESBG confirms that the current "issuer pays" model bears the risk of conflicts of interest, which have to be minimized, managed and disclosed, as foreseen already in the 2009 Regulation.

(35) What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the "issuer-pays" model? If so please indicate which alternatives appear to be the most feasible ones and why.

ESBG doubts that the alternatives would considerably reduce conflicts of interest; concretely ESBG members consider that the risk of conflicts of interest is inherent to the "subscriber/investor pays" model, the "trading venues pay" model" and the "government as hiring agent" model. Taking into account funding difficulties related to the "public utility" model, ESBG considers that the "payment-upon-results" model constitutes the best alternative, although this concept would be linked to a high administrative and bureaucratic burden. Therefore the "issuer-pays" model also stays a good option, under the condition that the 2009 Regulation is firmly applied. Furthermore the 2010 revision adds an important element, namely enhanced disclosure obligations for CRAs towards market participants and the public in general.

(36) Are there any other alternatives to be considered? If so please explain.

While maintaining the "issuer-pays" model, it should be supplemented by disclosure and publication, and thereby transparency, of fees of CRAs, in a manner that the information is verifiable.

(37) Are there any other issues that you consider should be tackled in the forthcoming review of the CRA Regulation?

Enhanced disclosure in structured finance, as initially envisaged in the 2010 revision of the Regulation, is in ESBG's view crucial. Against this background, ESBG notes that Article 8 (information on structured finance and access to rating information) forms not part of the text adopted by the plenary of the European Parliament on 15 December 2010, which is reflecting the agreement with the Council, and has instead been replaced by Recital 5. ESBG underlines that the further work of the Commission in this respect is important.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5967 billion (1 January 2008). It represents the interest of its Members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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