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## Response to ESMA's call for evidence on competition, choice and conflicts of interest in the CRA industry

Evaluation of the existing rules should not distort  
efficiency of rating markets

## General remarks

Bundesverband der Deutschen Industrie<sup>1</sup>, Deutsches Aktieninstitut<sup>2</sup> and Verband Deutscher Treasurer<sup>3</sup> welcome the opportunity to respond to ESMA's call for evidence regarding the rating industry. Our comment represents the view of corporates depending heavily on rating agencies in order to successfully issue bonds on capital markets.

While most of ESMA's specific questions are relevant for individual companies, we would like to submit some general considerations on the functioning of the credit rating industry, and especially with regard to competition, choice and conflicts of interest.

We recognise that ESMA's call for evidence is launched in the context of the reviews required under the last round of CRA Regulation, CRA III. Generally, German corporates do not see a need for fundamental regulatory changes at this stage, and in the light of the changes that have already been made to the industry in recent years now being supervised by ESMA.

Rather, we are concerned that potential measures intended to adjust the market structure might come to the detriment of corporate issuers' access to capital markets. Such implications would be undesirable and indeed, anachronistic in a time when the EU Commission is seeking to promote capital financing and consulting in parallel on ways to improve efficiency of capital markets financing by implementing the capital markets union.

Rating agencies perform an important function in reducing information asymmetries between borrowers and lenders and thereby promoting investor confidence and, in turn, facilitating companies' access to finance. In particular corporate bond ratings are a widely recognised indicator of credit quality by investors and issuers alike.

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<sup>1</sup> Bundesverband der Deutschen Industrie e.V. is the umbrella organisation of German industry and industry-related service providers. It represents 38 industrial sector federations and speaks for more than 100,000 private enterprises.

<sup>2</sup> Deutsches Aktieninstitut e.V. represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and in Berlin.

<sup>3</sup> Verband Deutscher Treasurer e.V. is the official German association of Corporate Treasurers representing more than 950 treasury professionals from 450 companies.

While events in the sub-prime crisis during 2007 and 2008 revealed undeniable flaws in the functioning of some parts of that market, several rounds of regulation have since been enacted in order to strengthen the CRA industry. CRAs themselves have also learned their lessons from the crisis and investors are under a regulatory obligation to improve their own credit analysis. We regret that the call for evidence seems to give little attention to those developments.

We favour choice in the CRA industry, which should however not come at an undue administrative or cost burden for issuers, nor to the detriment of issuers' ability to finance their business via bonds placed in international capital markets. The current CRA regulatory framework already includes a number of measures intended to promote competition, including certain exemptions for smaller CRAs, greater visibility provided to CRAs through the European Rating Platform on ESMA's website, and a requirement for issuers to consider mandating a small CRA when requesting two or more ratings. We also note that a significant number of approximately 30 CRAs have registered with ESMA and we understand further applications are being made.

Therefore, the goals already achieved with regard to competition should not be undermined by measures that might distort the efficiency of the rating market as a whole:

- Most significantly, we continue to be strongly opposed to extend the mandatory rotation to other assets beyond re-securitisations. Issuers' choice of a CRA is fundamentally driven by the credibility of the CRA as a prerequisite of the ability of issuers to efficiently place their bonds with investors. Interfering with that choice would not only impose an unwarranted cost on issuers. As only a restricted amount of CRAs are accepted by the investors a limitation of the use of these CRAs by an external rotation rule would endanger the ability of issuers to finance their business by issuing bonds.
- Furthermore, conflicts of interest inherent by the issuer-pays model are already addressed by the existing rating regulation. The investor-pays model represents no alternative to the recent pay model as it lacks feasibility and leads to new conflicts of interest.

## Our answers to selected questions

***Q10: Please explain the impact on your business of the following obligations and provide an estimate of your costs of complying with each of these obligations from 2013 to present where possible:***

[...]

***(2) to document the CRAs appointed.***

With regard to the documentation requirement ESMA should be aware that Art. 8d states that if the issuer does mandate at least two CRAs and does not appoint at least one credit rating agency with no more than 10 % of the total market share this shall be documented.

Therefore, Art. 8d only requires issuers to evaluate the availability of a smaller CRA and to document the reasons for **not** mandating the smaller CRA. Art. 8d does not oblige issuers to mandate a smaller CRA if **possible**. Nevertheless, the latter seems to be incorrectly claimed by ESMA in no. 19 of the consultation paper.

***Q18: Please explain what, if any, further measures could be taken to increase the quality and independence of ratings, giving reasons for your answer.***

Basically, unsolicited ratings are from a poorer quality than those which are mandated as the CRA does not have the same access to information provided by the issuer. Therefore, investors should be unambiguously informed whether the rating is unsolicited or not. This is what Art. 10 para 5 states: A credit rating agency shall clearly distinguish unsolicited ratings with a different colour code.

Nevertheless, this rule does not work very well in practice. Some rating agencies do only refer in an accompanying text that the rating is unsolicited. This is not sufficient as the table providing the rating, which is the relevant information source for investors, often does not clearly label the rating as unsolicited. Therefore, CRAs should be obliged to mark the rating provided directly in the table regarding its status (unsolicited or not).

**Q23: Please explain whether mandatory rotation should be extended to other asset classes. [...]**

No, mandatory rotation should not be extended to other assets and especially not to corporate bonds for the following reasons:

- Mandatory rotation is likely to deteriorate rating quality. Rating agencies build up expertise through their ongoing interaction with companies. This is important for all businesses, and in particular for larger and more complex ones. The experience gathered will be lost when the rating agency is forced out of the rating assessment of a certain bond due to the rotation rule.
- Today large issuers regularly solicit two rating agencies in order to gain acceptance in the market. In the absence of a larger number of internationally accepted players, a rotation requirement might force issuers to mandate only one CRA or in extreme, no internationally accepted CRA is no longer available. As a result, acceptance of the bond issuance among investors will decrease as they often require issuers to solicit at least two rating agencies.
- Rotation would lead to rating volatility even in the absence of changes in the quality of the assessed bond. CRAs have different methodologies and different rating scales, and a “handover” of a bond from one CRA to the next would frequently be accompanied with a rating change, with the consequence of negatively impacting issuers’ ability to plan the timing and pricing of their debt issuance.
- Furthermore, the CRA Regulation already provides for the rotation of analysts within the CRAs to ensure independence from the issuer. This rule should be sufficient.
- The external rotation rule would probably increase prices charged for rating services, since each of the internationally accepted rating agencies could be certain of being solicited by an issuer at some point of time. This contradicts regulatory efforts to increase competition.

**Q28: 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 should be taken and what impact you think these would have on the quality of credit ratings.**

No, further measures should not be taken, especially not regarding the model of remuneration. We believe that the issuer-pays model provides for a simple and cost-efficient solution, as it obliges issuers to pay for the rating thus providing an additional service to investors. Therefore and due to the following arguments we oppose a systemic change towards the investor-pays model:

- The problem how the public good “rating” can be offered exclusively to paying investors is yet unsolved. Due to the variety of technological means to spread information quickly to a large number of market participants or to the general public this will be almost impossible. History shows that a switch from the investor-pays to the issuer-pays model in the 1970s was closely linked to the spread of photocopying-machines at that time, which allowed for the cost-efficient multiplication of rating-reports. As a result of this “free-rider-problem” the great majority of investors will not be willing to pay for the rating. If no one is willing to pay, the rating market could collapse in an extreme scenario.
- To remain high quality standards with regard to the rating the issuer would be forced to disclose information to every CRA producing a rating on an investor’s behalf. Confidential information, often related to competition issues, are thus affected. However, it remains questionable how this confidentiality can be assured. Additionally, the dialogue between issuer and CRA is inevitable for a rating of high quality. Concerning a larger number of CRAs mandated by the investors, this dialogue would bind further resources in the companies. Regarding the additional costs arising therefrom, especially small and medium sized enterprises will be hit disproportionately in order to maintain their unhindered access to capital markets.
- Even if it was possible to find means of exclusion which guarantees that only paying investors have access to the reports of the CRA, especially small and medium sized issuers would have difficulties in obtaining a rating due to a lack of investors’ demand. This is what we already see in the equity market where SME have great difficulties to obtain research from professional analysts. These companies would presumably face obstacles in placing their bonds on the market without offering concessions.

- The investor-pays model may likewise lead to conflicts of interest as well. An investor is normally interested in an understated rating in order to receive higher interest rates. Therefore, incentives to influence the rating process by the investor are not ruled out by this model.

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