Comments of HVB Group

on

CESR's technical advice to the European Commission on possible measures concerning credit rating agencies

HVB Group welcomes the opportunity to comment on CESR's Draft Advice.

HVB Group is the second largest private-sector bank in Germany and together with Bank Austria Creditanstalt the undisputed market leader in Austria. With over 60,000 employees, 2,062 branch offices and over 9.8 million customers, we are Number One in the heart of Europe, meaning in our core markets of Germany, Austria and in the dynamic growth region of Central and Eastern Europe where we have positioned ourselves as a leading banking network. We focus on European retail and corporate customer operations, supplemented by customer-related capital market activities.

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I. Preliminary remarks

In the view of HVB Group the IOSCO Code should form the basis for dealing with this subject on a European level. When it comes to individual questions, it might be necessary to be more concrete and make adjustments in line with European legal requirements. If necessary, supplements should not be excluded in principle. However, HVB Group is of the opinion that special European regulations should only aim to make the rating process more efficient and not result in having ratings for European companies differ in terms of quality from ratings for companies outside the EU. This would have negative consequences for the acceptance of European issues on the market.

The IOSCO envisages self-regulation in implementing its Code but does not exclude introducing more far-reaching measures if this approach is not successful. CESR should also pursue this concept within the scope of the advice. However, it should not be proposed to the Commission that detailed regulations might even have to be created by national regulators.

It would be conceivable to require rating agencies acting in the EU to take over the IOSCO Code or to explain publicly why certain regulations of the Code are not fully implemented ("comply and explain").

Notwithstanding, HVB Group would like to state in advance that **Option 6** from the catalog of options submitted by CESR (observation of market development), linked to the threat of more far-reaching measures, should be proposed in the advice if it appears that the rating agencies are not implementing the regulations of the Code satisfactorily.

Registering credit rating agencies (CRAs) across the board is not considered necessary. Registration of rating agencies as "External Credit Assessment Institutions" (ECAI) under the Capital Requirement Directive (CRD) should not be mixed with the general requirements imposed on the agencies in the scope of their actual business. On the one hand, an attempt should be made to minimize duplication by regulatory authorities and excessive paperwork for agencies. It would help here if the IOSO Code was taken as a basis within the scope of the CRD regulations for external rating. On the other hand, the requirements for rating agencies to ensure high quality of external ratings in assessing equity capital requirements of banks constitute a special subject and should not affect general regulations. This applies especially to the rating methodology.

Finally, HVB Group would like to emphasize that no matter how good a codex for CRAs may be, it only works well in actual practice if there is a corresponding enforcement system in place. HVB Group believes that this function could be performed by an arbitration board. The

arbitration board could not only settle differences of opinion between CRAs, issuers and addressees of ratings, but also discuss controversial principles, in particular in applying and interpreting the codex with the CRAs, issuers and other experts and thus ensuring uniform application internally. However, when the board is created, it must be ensured that the arbitration board does not become a revisor of individual ratings.

Below HVB Group wishes to reply to CESR in connection with a large number of the questions asked.

II. Questions

1. Definitions

Question 1 and 2: Do you agree with the definition of credit rating agencies? If not, please state your reasons. Do you agree with the definition of credit ratings? If not, please state your reasons.

CESR correctly assumes that "*any organization whose ratings are recognized for regulatory purposes by a financial regulatory authority*" must be removed from the definition of the concept of "credit rating agencies." Incidentally, IOSCO also deleted this passage in the framework of the Code of Fundamentals for Credit Rating Agencies presented in December 2004.

CESR has also defined credit rating correctly. It is identical with the IOSCO definition.

Question 3. Do you think that issuers should disclose rating triggers included in private financial contracts?

HVB Group does not think that issuers should be required to publish the use of "rating triggers" in private financial contracts. If problems arise from such contracts for the future solvency of issuers, rating agencies should take this into account already in their ratings. In this context it should be noted that the Prospectus Directive (2003/71/EG) offers enough protection mechanisms.

Question 5. Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.

The use of ratings in European legislation should not be encouraged beyond the regulations on external rating in CRD. Using ratings in further European legislative initiatives could easily lead to restrictions on market access.

2. Competitive Dimension: Registration and Barriers to entry

Question 1 and 2 Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed? Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?

On the market for ratings there are some "natural" market access barriers, in particular as a result of demands on rating agencies made by investors and issuers in terms of quality. It is therefore unlikely that these natural barriers can be legislated out of existence. As HVB Group sees it, legislative initiatives should therefore be confined to areas which are essential for the quality of the rating. These are mainly disclosure of conflicts of interest and the lack of an arbitration system for the relationship between CRAs and issuers.

3. Rules of Conduct Dimension

Question 1. To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

In order to adequately address possible conflicts of interest, the rating agencies should take steps internally and disclose them together with any conflicts of interests which are the result from their business activities. If a Code of Conduct for CRAs is established at a European

level, the CRAs should use this according to the motto "comply and explain." Enforcement should be handled by an arbitration board (see above).

Question 2 and 4. Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban? To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

Rating agencies should not be prohibited from offering advisory service, although this activity does indeed harbor a potential conflict of interests. CRAs should, however, be required to disclose whether and to what extent advisory service has been agreed. Moreover, ratings of companies with which consulting agreements have been signed must be marked separately as such.

Nor does it make sense for CRAs to have separate areas for credit ratings and credit advisory services. So-called "Chinese walls" should be established between these service sectors if a rating is underway. But the people who conducted the rating should be entitled after the rating to apply their knowledge in performing credit advisory service. If a personnel is strictly separated here, the result would only be poorer rating or advisory quality. The reverse case, namely that the employee worked in the credit advisory area and now performs rating services should not be prohibited either. However, this should be noted in the disclosure.

Question 5. To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?

Payment of rating agencies by issuers should be disclosed. While influence on the rating cannot be deduced from this fact, this should be shown in the disclosure by distinguishing between "solicited" and "unsolicited."

7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?

When financial and other (especially indirect) links exist, the CRAs should take the required internal measures to ensure that such links will not influence the rating results and disclose these measures as well as all direct and indirect financial or other links in a general form. Such links should be mentioned in the disclosure.

4. Fair Presentation

Question 1. To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?

Already in their own interest, CRAs naturally want their staff members to be highly qualified. At the same time, rating agencies should take the required internal measures to ensure that the skills required for top quality ratings are available and should disclose these measures. However, this should be a general obligation, not one referring to each individual rating. Disclosure on the company's website should suffice here.

Question 3. Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?

Undisclosed methodologies relevant for the rating result can lead to biased ratings by market participants but also by issuers themselves. HVB Group therefore thinks that the methods of the CRAs must be made accessible to the public. If the CRAs disclose these methods, not only will market participants and issuers be enabled to verify the rating on the basis of the method but the rating process itself will become more credible. However, to avoid

misunderstandings here, this disclosure obligation refers only to the method and not to presentation of the application in a particular case.

Question 4. Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?

We do not favor regulation of rating methods by regulators. Ratings are generally of good quality and more intensive regulation would not make them better. Moreover, this would prevent competition in methods among the agencies. This point is particularly important for further development of ratings. The corresponding provisions of the IOSCO Code and the associated self-regulation are sufficient.

Question 5. Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?

Relevant changes in methodologies should be disclosed to issuers before they become effective. This would enable market participants to adjust to the changed methods in advance.

5. Relationship between issuers and rating agencies

Question 1. Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?

The provisions of the Market Abuse Directive and the IOSCO Code address the access of rating agencies to insider information adequately. No more regulations are necessary

Question 2. What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instruments?

Issuers should not be required to disclose imminent changes in ratings. This is the job of the rating agencies.

Question 7. Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?

The IOSCO Code provides a good foundation for ensuring that issuers are adequately informed about the reasons for certain rating results. No further action needs to be taken.

Question 8. In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRA's opinion?

Issuers should have a right of appeal if the rating in question is based on objectively false facts or calculations, incomplete information or obviously wrong evaluations. This right of appeal should be limited in time and exist already before the rating is disclosed. CRAs therefore must inform the issuers before the rating is disclosed. This also applies to unsolicited ratings.
If the differences between issuers and CRAs cannot be settled by the dialog initiated by the appeal, the conflict should be taken to the arbitration board. This should not impair disclosure of the rating. The ongoing arbitration proceedings should be mentioned only in the disclosure.

Question 9. Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?

The provisions of the Market Abuse Directive and the IOSCO Code are sufficient to ensure that the information published by CRAs is accurate.

Question 10. Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?

Records should have to be kept for <u>at least</u> five years.

Question 11. Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?

We do not believe it makes sense to introduce measures to establish a rating agency data room. Confidential internal information is always only passed on bilaterally and is not available to third parties. Alone for this reason the database would be incomplete and impractical.

6. Regulatory Options Concerning Registration and Rules of Conduct For Credit Rating Agencies

Question 1 and 5. Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:
- A full registration/regulation regime based upon detailed criteria;
- A lighter registration/regulation regime essentially based upon the IOSCO Code;
- To assess compliance to IOSCO Code Fundamentals in a parallel process to CRD's recognition;
- A third party's certification or enforcement of the IOSCO Code;
- Relying upon rules covering only specific aspects of CRAs' activity;
- Monitoring the market developments.
To what extent is a joint treatment of rating agencies by banking and securities regulators desirable?

Attention is called here to the preliminary remarks above.

Question 3. Do you think the IOSCO Code of Conduct is conducive to reducing or increasing competition?

In the opinion of HVB Group, the IOSCO Code will not increase or reduce competition. Nor is this the primary focus of the Code. On the contrary, the "rules of the game" were defined for existing competitors. Thus the relationship to the issuer acquired special significance.

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