

COMMENTS TO CALL FOR EVIDENCE BY ESMA ON COMPETITION, CHOICE AND CONFLICTS OF INTEREST IN THE CREDIT RATING INDUSTRY

I. GENERAL REMARKS

INVERCO (Spanish Association of Collective Investment Institutions and Pension Funds) welcomes the opportunity to comment on the call for evidence by ESMA on “Competition, Choice and Conflicts of Interest in the Credit Rating Industry”. INVERCO represents more than six thousands collective investment schemes and more than 1,300 pension funds, with assets under management that exceed EUR 420 billion. Collective Investment Institutions (CIS) and Pension Funds managers use external ratings as part of their investment processes and additionally, sometimes, because of regulatory requirements on asset eligibility. Therefore, INVERCO has a keen interest in a well-functioning market of credit rating agencies.

Additionally to the use of external ratings in assessing counterparty and credit risk, UCITS Directive and AIFMD entail extensive internal assessment requirements for asset managers with a concrete obligation to carry an own internal risk management process when assessing the counterparty and credit risk of each investment. Therefore, asset managers do not exclusively rely on external ratings but they are a part of their credit assessment processes.

However, the internal risk analysis employed by an asset manager varies upon its size, as well as the nature, scale and complexity of its activities. Large sized asset managers employ several teams for the internal risk analysis, such as portfolio managers, credit analysts and risk officers. This is not the case for smaller firms that rely more on external ratings. Moreover, even for larger size managers, it is difficult to cover all segments of the market, for instance in the case of a new investment solution. Therefore, external ratings remain an important source of information for CIS and Pension Funds.

As a general comment, INVERCO would like to stress that external ratings are used across the financial sector as a common language for example for investors who prefer/or need because of regulatory requirements, to have the limitations of the investment universe defined by reference to external ratings, or in the case of collaterals for repos and swaps and in general in those cases where external ratings are used to limit credit exposure in investment contracts. Otherwise, it would be very difficult to find a way to agree with an external counterparty when choosing for example which type of collateral could be posted. The use of ratings in those cases, becomes a tool of common understanding for the investors and the asset managers as they can be followed from both and ensure the common understanding of the elements of their investment agreement. Moreover, it provides investors with the capacity to compare information and follow the assessment of their portfolio.

In order for external ratings to maintain their role as “common language” the stability in the regulatory regime is important. The European Union began supervising CRAs in 2009 and has since modified the regulatory framework every two years. This frequency of change creates uncertainty. Therefore it must be addressed the need for the current regulatory regime to remain stable so that its full impact can be properly evaluated.

II. COMMENTS TO SECTIONS 6.3, 6.6. AND 6.7 OF THE CONSULTATION.

Please find below some high-level comments on sections 6.3, 6.6. and 6.7 to the Consultation.

6.3 Independence and quality of credit ratings

INVERCO recognizes the conflict of interest inherent in the “*issuer pays*” model. No business model is “conflict free”. It is however not clear that an alternative model whereby is viable or could make the rating activity a sustainable one. Changing “*who pays*” (or selects) CRAs will not eliminate the potential for conflicts; whereas it would almost certainly contribute to deteriorate the performance quality and transparency because: (i) the industry would not have appropriate resources and this would be an obstacle to attract talented professionals; and (ii) ratings would not be freely available to the broader market, as investors would have to pay for them. Therefore INVERCO believes that as in other business models, the relevant point is, given the existing conflicts, regulating measures to mitigate and manage said conflicts of interests. To that aim, the current regulatory framework for the CRA industry provides the appropriate level of measures for the management of conflicts of interest.

For many users of ratings the research, analysis and access to information capacity of CRAs is one of the main advantages of credit ratings, as long as their independence and neutrality is safeguarded. Therefore, the main driver of regulation should be the quality of the ratings provided by CRA over enhancing competition as there is no evidence that more competition would necessarily increase quality (see comments to point 6.7).

6.6 Mandatory rotation

It is still too early to assess the full impact of the provisions designed to facilitate growth for smaller CRAs, such as the mandatory rotation on and off the re-securitisation sector. Therefore said measure should not be extended to other sectors given its potential negative consequences which have not yet been sufficiently addressed. The possible negative outcomes of this measure mainly derive from the need for credit ratings to be stable because of their role of “common language” between market players. Mandatory rotation might affect the continuity and comparability of credit ratings published by CRAs and investors ability to maintain a stable investment portfolio.

It might also affect the quality of CRAs and make the performance of CRAs very difficult, if not impossible, to measure as a CRA has to effectively withdraw its rating before the performance of a rating can be established.

6.7 Competition between credit rating agencies

As already stated, the focus of regulation should be on the quality of CRAs, and how that can be rewarded, rather than on the number of players. Merely increasing the number of CRAs will not necessarily improve the quality of ratings or their usefulness. It may be preferable to stimulate competition between existing players rather than to expect new entrants to enhance competition. Beyond a small number the marginal benefit of additional ratings soon becomes close to zero.

Barriers to entry to the credit rating business include intellectual property, reputation and regulation. There is no reason however why a small firm could not establish itself in business with a narrowly focused offering which can claim either better quality analysis or a different methodology to the big players if it believed that it had a good business model. It would take some time to establish a reputation but this is the case for many smaller businesses. It is therefore not clear whether any intervention in the market place would actually produce lower barriers to entry.

Moreover, disturbing the market imposed supply-demand discipline might have negative and unintended consequences. If the industry's incentive structure is altered through a regulation that imposes the use or disuse of certain CRAs, competitive forces that drive CRAs toward higher quality ratings might be undermined.

Finally, given the continues changes that the landscape of the CRA industry is actually going through, mainly due to the advance of the digital economy which affects all businesses based in the provision of information, considering additional regulatory initiatives for the CRA industry is premature, and may inadvertently prevent innovation.

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