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Comments of the Zentraler Kreditausschuss[1] on CESR's consultation paper "The role of credit rating agencies in structured finance"

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[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the co-operative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the mortgage banks. Collectively, they represent more than 2,200 banks.

The Zentraler Kreditausschuss (ZKA) thanks CESR for the opportunity to comment on its consultation paper “The role of credit rating agencies in structured finance”.

The credit rating agencies (CRAs) play an important role in the market for structured finance instruments: the confidence of market participants in the quality and reliability of ratings is a key prerequisite for the smooth functioning of this market segment. The current financial turmoil was triggered by a widespread loss of confidence in the quality of asset-backed securities (ABS). Shortcomings in the rating of these products, while not the sole cause, certainly contributed to the problem. These shortcomings must be remedied. This is primarily the responsibility of CRAs themselves.

It also makes good sense, in our view, to examine whether improvements need to be made to the regulatory environment governing rating agencies. We therefore welcome the fact that regulators are investigating the role of CRAs in the market for structured finance.

Measures put in place by the agencies, market participants and regulators should aim at ensuring the smooth functioning of the securitisation market. This market segment contributes strongly to the efficiency of the financial markets, the distribution of risk among market participants and the banks’ risk management processes. With this in mind, we warmly welcome the considered analysis in the consultation paper. The German banking industry largely shares CESR’s assessment and agrees with many of its proposals.

This also applies to the definition of structured finance products used in paras 35 and 36, which we strongly support. The term “structured finance product” is not always used consistently. So it must be absolutely clear when discussing the role of rating agencies in the market for structured finance exactly what categories of product are meant. It is important to establish that Pfandbriefe and other covered bonds do not fall within the scope of structured finance. Pfandbriefe are collateralised bank bonds; the bank is the issuer, the collateral remains on its balance sheet and there is no tranching. Although all major CRAs have developed separate rating methods for covered bonds, these do not take adequate account of the special features of the Pfandbrief.

Our replies to the specific questions posed by CESR in its consultation are as follows:

1. Transparency

80. Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?

Ratings are no substitution for adequate risk analysis on the part of investors. To undertake such analysis, however, investors need access to the relevant information.

We therefore support CESR's view in para. 79, that rating agencies need to clearly communicate the essential characteristics and limitations of their ratings. It is especially important, in our view, to improve transparency on the essential characteristics of ratings since this is where a lack of clarity often exists. In the opinion of our member banks, the major considerations in this context are

- the substance of the rating (probability of default or expected loss),
- the time horizon of the rating,
- the exact definition of default (whether it includes or excludes the timeliness of payments),
- the assignment of probabilities of default to ratings. (Sometimes a rating agency applies the same rating to products with different probabilities of default. This makes it more difficult for the market to evaluate such ratings. Any one rating should always be based on the same probability of default).

We also believe that CRAs should provide more extensive information about the limitations of their ratings. This should not, however, be confined to a general statement to the effect that ratings are merely an indication of the probability of default or expected loss and are not intended to be a comprehensive evaluation of risk. Agencies should highlight the differences between sovereign or corporate bonds on the one hand and structured finance products carrying the same rating on the other. This could be done in their rating reports, for instance. They should also draw attention to the specific risks of different tranches stemming from the size of the tranche, certain market developments or the risk of default of the underlying assets.

90. ***Do you agree with CESR's view that although there has been improvement in transparency of methodologies, the accessibility and content of this information for complex structured finance products requires further improvement in particular so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings?***

We support CESR's view that rating agencies need to further improve the information they make available about their methodologies for the reasons outlined in our reply to the previous question. It is true that CRAs now make information about their models available. But there is still a lack of

certain key details which would make it possible to verify their risk analysis. Our member banks see a particular need for information about the stability of ratings. When rating structured finance products, CRAs should provide concrete details of the assumptions used to calculate probabilities of default, the assumed correlations between the elements of any secured portfolios, the stress tests used in the structural analyses and the consequences of different scenarios for the rating.

97. ***Do you agree that there needs to be greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as rating reviews?***

Our member banks are generally satisfied with the information made available in connection with the first-time rating of structured finance products. We nevertheless strongly support the recommendation in para. 96, because this information is highly important for investors and issuers. Rating agencies should also make clear under which circumstances a change in methodology will result in adjustments to ratings of new issues only and when a rating review of existing securities is considered necessary.

100. ***Do you agree that there needs to be greater public and standardised information on structured products in the EU? How would this be best achieved?***

Discussions are already underway both between the European Commission and the financial services industry and within the industry itself on how to improve transparency in the market for structured products.

2. Monitoring

104. Do you agree with CESR that contractually set public announcements on structured finance performance would not add sufficient value to the market to justify the cost and possible saturation of the market with non-material information?

We share CESR's view that a contractual obligation for rating agencies to publish information on the performance of structured products would not deliver adequate added value, especially given that this information would essentially be retrospective. We would, however, welcome it if agencies provided more extensive information about possible future developments and their possible implications for ratings, such as the potential effects of foreseeable macroeconomic or other developments on the markets for structured finance products relevant to securitisations.

112. Do you agree that the monitoring of structured finance products presents significant challenges, and therefore should be a specific area of oversight going forward? Are there any particular steps that CRAs should take to ensure the timely monitoring of complex transactions?

We firmly believe that timely and extensive monitoring of structured finance products by the rating agencies is essential if their ratings are to be of high quality and up to date. It is primarily the responsibility of CRAs themselves, in our view, to have appropriate organisational arrangements and internal processes in place. We welcome plans by some agencies to assign different teams to the initial rating process and the monitoring of existing ratings because the two activities place different demands on analysts. This will also have the advantage of avoiding potential conflicts of interest among staff. Furthermore, monitoring should not be confined merely to comparing expected and actual instances of default since this may lead to delays in adjusting ratings or rating methods. The monitoring process should include forward-looking macroeconomic and market analysis. In addition, there should be a regular exchange of information between different teams within a CRA to ensure the consistency of their ratings.

We are also in favour of updating the IOSCO Code of Conduct Fundamentals in order to make sure that certain minimum standards are met in this area. Given that the monitoring of ratings is an overarching issue, however, the new rules should not apply to complex financial products only. The monitoring frequency should depend on the type of rating. It would probably be sufficient to review the ratings of corporates once a year, for example. With structured finance products, on the other hand, ratings would need to be monitored and reviewed at least every three to six months under normal circumstances. And in exceptional, specifically defined circumstances, monitoring should be on a continuous basis.

This naturally means that rating agencies must have sufficient qualified staff to assign to monitoring duties. Here too, we would recommend including corresponding minimum standards in the IOSCO Code. We would also suggest that rating agencies consider lowering their upfront fees and raising monitoring fees for structured finance products. This would reduce the incentive for the agencies to focus primarily on new business and make investors and issuers more sensitive to the importance of monitoring.

3. Human Resources

118. Do you believe that the CRAs have maintained sufficient human resource, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business?

Our members believe human resources at the CRAs are generally sufficient in the field of first-time rating. When it comes to the monitoring of existing ratings, however, they consider that there is not always enough qualified staff to guarantee that monitoring is comprehensive and timely. This problem has become exacerbated by the rapid growth of the securitisation market since staffing levels have not risen proportionately.

We share CESR's view that CRAs should provide adequate information, at least to their regulators, about employee development. The present "comply or explain" regime assumes that the competent authorities are in a position to judge whether the minimum standards of the IOSCO Code are being met. The quality and number of staff are important factors in this respect.

120. Do you consider that the generally unaltered educational and professional requirements of CRAs' recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

We expect CRAs to regularly review the requirements that their analysts must meet and, if necessary, adjust them to reflect product and market developments. Given that ratings play a key role in the market for structured finance products, the agencies have a major responsibility to ensure the smooth functioning of this important market segment. But there is also an element of self-interest here: the expertise of their analysts is the CRAs' most valuable asset. Sub-standard staff would badly damage their reputation. The fact that the requirements to be met by staff have not changed is therefore not in itself an indication that analysts are less well-qualified than they used to be.

A more serious problem, in our view, is an excessive focus on quantitative models. This may have contributed to the development of increasingly complex products with considerable knock-on effects for the economy as a whole and to the relatively slow response of CRAs to the subprime crisis. Greater consideration should be paid to qualitative factors when rating structured products. It is, after all, the quality of the underlying assets which ultimately determines the size of highly-rated tranches. Depending on the type of structured financial product, therefore, more experts on macroeconomic and market developments should be involved alongside analysts whose expertise lies primarily in quantitative methods. In the interests of transparency, CRAs should make clear how these external factors have been incorporated into the rating process.

We are also concerned about the relatively high staff turnover, with analysts who have built up a certain level of expertise tending to leave the rating agencies. To guarantee that ratings are of an adequate quality, CRAs should make sure that important decisions – not least in the area of monitoring – are never taken without the involvement of experienced senior analysts.

125. Do you agree there is a need for greater transparency in terms of CRA resourcing?

In theory, publicly available information about staffing levels and qualifications might help to increase confidence in the quality of ratings. What is ultimately more important, however, is the experience that issuers and investors have with analysts in practice. Greater transparency would also be desirable with respect to CRAs' internal structure, organisation and decision-making processes.

126. Do you agree that more clarity and greater independence is required for analyst remuneration at the CRAs?

We see no real need for CRAs to disclose their remuneration policy. A more useful approach, in our view, would be for the agencies to try to maintain the quality of their ratings by reducing the level of staff turnover. Remuneration would naturally be a factor to consider in this regard.

4. Conflicts of Interest

133. Do you see the level of interaction between the CRAs and issuers of structured finance products creating additional conflicts of interest for the CRAs to those outlined above? Do you believe that any of these conflicts are not managed properly?

134. Do you agree that greater transparency is required regarding the nature of interaction between CRAs and issuers/ arrangers with regards to structured finance products and that there need to be clearer definitions of acceptable practice?

CESR points out quite correctly that rating structured finance products is an iterative process. Unlike when conventional bonds are rated, issuers of structured finance have various opportunities to adjust their product in response to indicative ratings with the aim of obtaining the desired result. There will inevitably be an exchange of information between issuer and rating agency before the final composition of an issue is decided on.

These circumstances theoretically give rise to a conflict of interest because the fee structure of CRAs means that they benefit from a high volume of structured product issues. Yet we are not aware of a single case of a rating agency failing to manage this conflict of interest sensibly. One

reason for this is doubtless that agencies are unwilling to damage their reputation for neutrality, especially since they do business with a number of clients.

Nevertheless, the smooth functioning of the various markets for structured finance products should not be undermined by allowing doubts about the neutrality of ratings to arise. We therefore welcome proposals aimed at eliminating or managing such conflicts of interest. Rating and advisory activities should be clearly separated from one another; a CRA's ancillary activities or interest in maximising earnings must not be allowed to influence the ratings it issues. The composition of an issue must always be made by the issuer on the basis of objective criteria. CRAs should confine themselves to delivering these criteria.

Since a certain amount of interaction between issuers and CRAs is inevitable where structured finance products are concerned, a careful distinction must be drawn between a necessary and unobjectionable exchange of information on the one hand and inadmissible advice on the other. It must be borne in mind that the financial markets are highly innovative; a strict definition of what constitutes admissible interaction might prove impracticable in the long run.

With this in mind, we do not consider it feasible to totally rule out theoretical conflicts of interest by defining what constitutes advisory activity. Rather, the aim should be to keep the risk of conflicts of interest to a minimum. We believe it is important to remember that it is very much in the CRAs' own interests to do so in order to safeguard their reputation.

CESR's proposals in paras 130 to 132 are therefore a step in the right direction, in our view. We too believe that the most sensible approach is the inclusion of a set of best practices in the IOSCO Code of Conduct Fundamentals, clear internal rules at the rating agencies which include an explicit ban on analysts issuing recommendations, full public transparency on these rules and effective monitoring by regulators of compliance.

Particularly serious conflicts of interest can arise if an employee of a rated company joins a rating agency or vice versa. These must be prevented. We believe it would make good sense for CRAs to conduct a "look-back" of ratings when analysts join a company whose products they have previously regularly rated.

In addition, detailed disclosure of methodologies would reduce the amount of interaction between issuers and agencies before a final decision is taken on a structured finance product and thus also mitigate the risk of conflicts of interest.

138. Do you believe that there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business?

We consider it crucially important for CRAs to provide clear and complete information about their internal definition of ancillary business. Market participants would then be in a position to assess how the agencies deal with this question. This is an issue which has been debated for many years without a satisfactory solution having been found. Given the overarching significance of this matter for all parties involved, we believe that CRAs, market participants and regulators should draw up a joint definition, which should then be implemented by the agencies in full.

142. Do you believe that the fee model used for structured finance products creates a conflict of interest for the CRAs? If yes, is this conflict of interest being managed appropriately by the CRAs?

Every service provider should be free to set its own prices. In principle, every pricing model carries the risk of a potential conflict of interest. We are not in a position to pass definitive judgement on whether or not CRAs have managed this theoretical conflict of interest appropriately.

An important factor alongside price is the quality of a CRA's ratings. Publicly accessible, regular and standardised studies by all CRAs on rating migration would, we believe, be an important consideration in an issuer's decision as to which agency to mandate.

146. Do you agree with CESR that there needs to be greater disclosure of fee structures and practices with particular regard to structured finance ratings so as to mitigate potential conflicts of interest?

Owing to the freedom for service providers to set their own prices and the oligopolistic nature of the ratings market, we consider it essential for the fee structures of CRAs to be completely transparent. This also goes for changes in fees. Greater transparency concerning the composition of fees would also be helpful.

5. Regulatory environment and concluding remarks

164. Do you agree with CESR's view of the benefits and costs of the current regime?
170. Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

We generally agree with CESR's assessment of the benefits and drawbacks of the two alternative regimes.

A formal regime may well run the risk of CRAs no longer being perceived as independent organisations competing both among themselves and with sophisticated issuers and investors to offer the best possible quality of service.

As far as the effects of regulation on the competitive situation are concerned, two diametrically opposed scenarios are conceivable. Extensive regulation which set stringent requirements for new entrants to the market might further exacerbate the problems that already exist. Yet it could also be argued that, if a new CRA succeeded in obtaining regulatory recognition, this official "stamp of approval" would actually make it easier to enter the market and become established. It is therefore possible that an agency's track record would cease to be the sole criterion for judging its performance. This consideration was behind the introduction at the end of June 2007 of the requirement for rating agencies to register as NRSROs with the SEC.

It is true that the current regime gives regulators no power to investigate whether CRAs are complying with the IOSCO Code or to enforce complete application of the code (paras 166A and B). The fact that CRAs do not implement the IOSCO Code of Conduct Fundamentals in full is expressly permitted by the current regime as long as they disclose and clearly state the reasons for their non-compliance.

We believe one of the fundamental elements of the current regime is that the CRAs have to provide regulators with the information they need to monitor whether agencies are following their own internal rules and complying adequately with the IOSCO Code. It is up to the CRAs to ensure that regulators receive this information, in our view. The benchmark could be the information which agencies registered as NRSROs in the US are required to disclose to the SEC. This information should be made available to all the regulators responsible for CRAs to ensure that authorities worldwide have access to the same data. This in turn is a key prerequisite for consistent treatment of the credit rating agencies.

It cannot, in our opinion, be automatically assumed that more stringent regulation would offer CRAs a greater incentive to take steps to avoid future failings in ratings or the rating process (para. 166C). A high standard of quality in the rating process is one of the cornerstones of the CRAs' business; this is the basis of market participants' confidence in their ratings. It is in the best interest of the agencies to maintain this quality. Recent developments show what effect a loss of confidence in ratings can have on the CRAs' earnings prospects.

177. Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/ regulation?

The ZKA supported the existing regime based on the IOSCO Code of Conduct Fundamentals and the "comply or explain" principle because it takes better account of the specific aspects of rating than could an extensive, highly detailed regulatory regime or a registration requirement for CRAs. Furthermore, the current system makes it easier for regulators to pursue a consistent approach worldwide. Naturally, this position is subject to the discussion of possible alternatives if the anticipated positive effects fail to materialise or it transpires that undesirable developments in the financial markets could have been prevented by some other form of regulation.

Until the start of the financial turmoil in the middle of last year the German banking industry saw no reason for the regulatory regime to be adjusted. The developments in the financial markets before and during the turmoil inevitably made it necessary to review this stance. We do not believe that the correct response at this stage would be to abandon the existing regime in favour of extensive formal regulation. The contribution of the rating agencies to the financial turmoil consisted primarily in their ultimately unrealistic assumptions concerning the probabilities of default and correlations between the different components of secured loans. Although, as pointed out in section 4, potential conflicts of interest exist which may result in CRAs gearing their activities in the market for structured finance to promoting an increase in new business, we are not aware of any cases in which misjudged ratings can be traced to conflicts of interest or inappropriate governance structures. It would therefore make good sense, in our view, to examine how CESR's monitoring of CRAs could be made more effective.

It is primarily up to the CRAs themselves to eliminate the shortcomings of rating methodologies which were revealed by the financial turmoil. This applies, first, to the models and assumptions which are used. In particular, the risk assessment of structured finance products should not only be based on quantitative models but should also take adequate account of qualitative aspects and important influences. Second, the monitoring process needs to be improved and mechanisms should be introduced to ensure a timely response to events with a potentially serious effect on existing ratings. Finally, there should be a regular exchange of information between groups of analysts within an agency so that the ratings of different assets will be consistent. We welcome the fact that CRAs have adjusted their models and underlying assumptions. This shows that they have responded to the need for corrective action.

Adjusting methodologies and shortening response times are not the only ways of enhancing the quality of ratings and providing users with more information. CESR addresses the most important aspects in its consultation paper: comprehensive, effective transparency on the main elements of

ratings, high quality staff, clarification of the interaction between issuers and CRAs and the separation of rating activities and ancillary services.

All these points can be dealt with effectively through additions or amendments to the IOSCO Code. We expect CRAs to adopt the corresponding adjustments to the IOSCO Code in their internal codes, keep deviations to an absolute minimum, substantiate the reasons for such deviations and provide regulators with the information they need to monitor the agencies competently.

Together with these measures concerning CRAs themselves, there is a need, in our view, for lawmakers, regulators and central banks to take a critical look at how they use ratings issued by credit rating agencies and explore possible alternative yardsticks.