Bundesverband
Investment und
Asset Management e.V.

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Per E-Mail

Mr. Fabrice Demarigny
Secretary General

Committee of European Securities Regulators
11- 13 Avenue de Friedland
F 75008 Paris
France

CESR's technical advice to the European Commission on possible measures concerning credit rating agencies
Ref: CESR/04-612b dd. November 2004

Dear Mr. Demarigny,

In response to your call for evidence, please find below BVI, the German association of investment fund and asset managers comments on the subject at hand. Our 75 member companies manage in excess of EUR 1000 billion in both retail and institutional investment funds as well as mandates. We hope you will find our comments helpful.

We would like to answer your questions as follows:

I. Introduction– Questions Page 15

1. **Do you agree with the definition of credit rating agencies? If not please state your reasons.**

We agree with the proposed definition in No. 37 that CRAs are "those entities whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities".

However, we would like to suggest to broaden the definition sufficiently in order to include any parent, sister and subsidiary undertakings to the extent that such entities may benefit from the market power of the CRA in order to influence the behaviour of other market participants. In particular, our members believe that provision of advisory/ancillary services by credit rating agencies outside the assignment and maintenance of ratings and the distribution of data directly related to ratings poses special risks, and as a result regulation of this area should be considered going forward.

Hauptgeschäftsführer:
Stefan Seip
Geschäftsführer:
Rüdiger H. Päsler
Rudolf Siebel

Eschenheimer Anlage 28
D-60318 Frankfurt am Main
Postfach 10 04 37
D-60004 Frankfurt am Main
Phone: +49 69 15 40 90 0
Fax: +49 69 5 97 14 06
info@bvi.de
www.bvi.de

We are referring in particular to the since two years ongoing attempts of Standard & Poors to press European investors into signing licence agreements on the international securities identification numbers (ISINs) which the S&P CUSIP Service Bureau (a department within the CRA) issues on US securities. In particular, the use of the rating agency name S&P in letters and local rating agency office personnel to push market participants into signing licence agreements for these not ratings related data services has put our member firms under perceived pressures by a rating agency. This threatens the integrity of the rating agency.
Such conduct of business which is not related at all to the ratings business should be strongly discouraged by regulators. A strict legal and operational separation of such activities from the rating business should be considered as requirement in the rating agency registration process with national regulators, e.g. in the context of registration as ECAI.

2. **Do you agree with the definition of credit ratings? If not please state your reasons.**

We agree with the proposed definition in No. 38.

3. **Do you agree with the definition of unsolicited ratings?**

We agree with the proposed definition in No. 42.

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

BVI members strongly believe that in the investment grade corporate bonds area there is a considerable need for improvement with respect to the timeliness as well content of the information delivered by issuers to investors, including but not limited to the disclosure of rating triggers. In particular, BVI sees the following areas for improvement in issuer information either through prospectus, road show material or website:

- *Availability of all prospectuses / roadshow material of all bonds in issuance, including private placements on issuer website*
- ***Disclosure of covenants in all bonds in issuance, including private placements, preferable also those contained in loan documentation Disclosure of cross default and rating triggers***
- *Disclosure of all material guarantees issued as well as dividend and profit sharing agreements*
- *Exact description of the issue in relation to the capital and corporate structure of the issuer*
- *Disclosure of Investor Relations contact , Treasurer, CFO data (name, address, phone, fax, email), and website of issuer*
- *Planed and maximum amount of funds to be raised by the intended issue as well as clear description of use of proceeds*

- *Provision of a lock-up period (no new issuance 2 weeks before and 2 days after regular capital market information dates (i.e. quarterly or annual reports))*

BVI together with the ABI Association of British Insurers has set up a practioner working group to make recommendations on how these information requirement as well improvements in financial covenants can be reached. We expect first results of these discussions before the end of the year.

5. Do you think that the use of ratings in European regulation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms?

BVI wishes to avoid any overregulation of the functioning credit rating agency market. Credit ratings should be objective, independent and accepted opinions about the relative credit worthiness of issuers or single issues. Only such rating agencies should be acceptable for regulatory purposes which can demonstrate market acceptance with investors and issuers. From our point of view the German market currently only accepts Fitch ratings (Fitch), Moody's Investor Services (Moody's), and Standard and Poors (S&P).
BVI does not see the need for a day to day government supervision of these rating agencies. These agencies are regulated as "NRSRO" and as "registered investment advisor" under the supervision of the US-SEC. Additionally the banking supervisory authorities of the EU member states will - after implementation of Basel 2 in EU law - certify credit rating agencies as "ECAI" if these agencies fulfil certain requirements, including a market acceptance test. Against this background we see little need for separate regulation of rating agencies and welcome the idea of a voluntary common code of conduct based on the IOSCO principles all relevant credit rating agencies should subscribe to. We continue to believe that the adherence of registered rating agencies to the requirements of such code of conduct can be primarily maintained by market mechanisms with the exception of the not rating related activities described in question 1, where regulation may be unavoidable. Individual misbehaviour of rating agency personnel in the European market place can be effectively dealt with the existing regulation on insider dealing and market abuse.

Government supervision beyond the registration of the CRA is likely not to result in any measurable improvement in the quality of the ratings. However, regulation and supervision will result in increased cost to be borne by issuers, asset managers, and ultimately the investors which will pay the cost of supervision through increased rating or rating data feed fees.
Based on the US experience since the 1930ties – we urge CESR not to base any regulatory investment management or reporting rules on credit ratings. Such rules only lead to the (implicit) pressure to subscribe to the

data delivery services of all registered rating agencies, thereby considerably in creasing cost and flexibility of investment management.
Finally, increased use of ratings in EU regulation will increase the barriers to entry for new or smaller rating agencies, and will cement the oligopoly of the big three agencies.

II. Competitive Dimension: Registration and Barriers to Entry – Questions Page 19

1. **Do you think there is a sufficient level playing field for CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed.**

As stated above the barriers to entry into the CRA market are historically first and foremost a function of the introduction and restrictive application of the NRSRO status in the US which over time has lead to a very limited number of acceptable rating agencies (and even this limited number has been more reduced by market exists). These effects cannot be overcome quickly and easily, however, it is positive that the SEC is according now the NRSRO status to new rating agencies. The SEC should be encouraged to accord NRSRO status to more foreign CRAs, at least for the markets and industry segments they are active in. Overall the standard for market acceptance of CRAs imposed by any regulator should not be too high.

2. **Do you believe that the coverage of certain market segments or certain categories of economic entities (such as SMEs) may be sub optimal? Are there any measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?**

The coverage of existing CRAs in the area of private equity and SMEs is not sufficient. However, this lack has not been felt in the past by the regulated investment management community as investments in these areas are outside the scope of most regulated investment funds, in particular UCITS. The envisaged report of the EU Commission on possible amendments to the UCITS directive, and in particular the opening up of alternative asset classes to UCITS managers, may after implementation in EU law create the demand for such ratings, and the corresponding rating agencies which issue them.

III. Rules of Conduct Dimension – Questions Page 24

1. **Policies and procedures for management and disclosure of conflicts of interest**

In the context of a code of conduct, BVI supports the introduction and disclosure of the CRA policies and procedures on the management and disclosure of conflicts of interest. A e.g. annual disclosure whether the said policies and procedures have been applied in each credit rating needs to be of substance. For example, the reasons should be explained in each case of non-compliance in order to avoid meaningless formulaic compliance statements.

2. Prohibition on ancillary services

As stated above, there needs to be a legal, brand, organizational and personnel separation of non rating related ancillary services from rating and directly related ancillary services offered by the CRA, in particular delivery of rating related data in order to avoid the use of the "rating agency cloud" by related entities which are delivering other services. As the rating agency at a minimum could sell ratings and ratings related data the barriers to entry created by the proposed functional separation will be low.

3. Structured Finance

Our members recognize that structured finance ratings are structure ratings, i.e. the rating level is depending on the negotiations between the issuer and the rating agency on e.g. appropriate levels of collateral or other forms of protection of investors. Currently there is no perceived need for regulation in this area.

4. Ancillary services and business relationships with issuers

In the context of a code of conduct, BVI supports the introduction and disclosure of the CRA policies and procedures on the management and disclosure of multiple business relationships with issuers in general and the issuer being rated in particular. A e.g. annual disclosure whether the said policies and procedures have been applied in each credit rating needs to be of substance. For example, the reasons should be explained in each case of non-compliance in order to avoid meaningless formulaic compliance statements.

5. Fee schemes

In the context of a code of conduct, BVI supports the introduction and disclosure of the CRA billing policies and procedures, including but not limited to the introduction and disclosure of a fee scheme. A e.g. annual disclosure whether the said policies and procedures have been applied in each credit rating needs to be of substance. For example, the reasons should be explained in each case of non-compliance in order to avoid meaningless formulaic compliance statements.

6. Unsolicited ratings

In the context of a code of conduct, BVI supports the introduction and disclosure of the CRA policies and procedures with respect to unsolicited ratings, as well as the disclosure in each case when a particular rating has been unsolicited.

7. Financial links or other interests

In the context of a code of conduct, BVI supports the introduction and disclosure of the CRA policies and procedures with respect to managing and disclosing financial links or other interests between a CRA and issuers or its affiliates or investments in general and the issuer or its affiliates and investments being rated in particular, as well as the disclosure how these policies and procedures have been applied in each credit rating.

III. Rules of Conduct Dimension – Questions Page 28

1. and 2. Analyst skills

In the context of a code of conduct, BVI supports the introduction and disclosure of the CRA policies and procedures with respect to managing and disclosing levels of skill of staff, as well as the disclosure how these policies and procedures have been applied in general. A disclosure in case of each credit rating seems not practical.

3. to 6. Rating methodology

From the point of view of asset managers it is positive when rating methodologies and rating benchmarks are made transparent in order to make ratings more comparable, e.g. on the basis of standardized questionnaires. Such questionnaires which BVI has developed in the area of fund ratings and rankings should contain a standardized system of questions which is based on common factors. Questions should not only relate to quantitative measures such as the quality of the ratings as expressed through so called “default studies”. They should also include questions relating to the qualitative aspects of ratings , e.g. the timeliness of rating actions in case of the home state government of the CRA. On the other hand it needs to be recognized that ratings are „an art and not a science“. Because of the important qualitative input into the ratings their results will never be fully computable. The strong qualitative element will also prohibit a full comparison of the ratings across different industries, sectors and regions. Based on these facts, we continue to believe that a code of conduct on the basis of the IOSCO recommendations will be sufficient. It is not demonstrated that more detailed and likely different regulation at EU level will improve the quality of rating results.

III. Rules of Conduct Dimension – Questions Page 36

1. to 10 . Market abuse

Our members continue to believe that behaviour of rating agency personnel in the European market place can be effectively dealt with the existing regulations on insider dealing and market abuse, as well as a code of conduct based on the IOSCO principles. There is no empirical demonstrated need for increased regulation beyond the existing regulations.

11. Rating agency data room

As a matter of principle, investors who bear the risk of default need at least the same access to in depth and high quality issuer information as the rating agencies themselves. We do not see any reason why rating agencies should get privileged and easier access to issuer company information at the expense of the credit research analysts employed by our members.

IV. Regulatory Options concerning registration and Rules of Conduct for CRAs – Questions Page 43

1. to 4. Policy options

Please see “Introduction”, question 5 above. Based on public responses thereto, the IOSCO Code of Conduct seems to strike an adequate balance between investor, issuer, and CRAs needs. At this stage no further EU regulation seems necessary.

5. Joint supervisory treatment of CRAs

We urge CESR to address CRAs on a joint treatment basis together with the relevant banking regulators in order to avoid any duplication or conflicts of regulation, e.g. registration of CRAs under the rules implementing Basel 2 in the EU should be sufficient for both the banking and securities regulators.

With kind regards

BVI Bundesverband Investment und Asset Management e.V.

(signed)
Rudolf Siebel
Managing Director

(signed)
Marcus Mecklenburg
Vice President