Comment on CESR's Consultation Paper on Credit Rating Agencies

Summary

The German Insurance Association (GDV) considers globally recognised binding minimum standards for the business of credit rating agencies (CRAs) as essential if both the quality of ratings and the efficiency of the rating process are to be maintained. We were in full support of the creation of the current self-regulatory regime with the publication of the IOSCO Code of Conduct Fundamentals for CRAs in 2004 and the establishment of CESR's monitoring framework for CRAs' activities in the European Union in 2006, and we very much welcome CESR's efforts to further improve regulation of CRAs in light of the experience with the current system.

In our view, the current regime can be regarded as a major step towards closing the regulatory gap which had previously existed in the market for credit ratings. Since the publication of the IOSCO Code, significant improvements in CRAs' business conduct have occurred. However, there are still some shortcomings, and we agree with CESR that there is a need for adjustments in the regulatory framework for CRAs in the European Union.

With respect to further regulatory action, a pragmatic approach should be adopted. From our point of view, the most important regulatory measure would be an amendment of the IOSCO Code. Some clarification of the wording of the Code – for example with respect to the disclosure of the type of rating – and the incorporation of additional provisions into the Code in order to take account of particular issues of concern which are currently not being dealt with adequately in the Code could provide CRAs and market participants with further guidance on acceptable practices and minimize potential disagreement over the interpretation of the Code. In addition, we believe that the creation of an arbitration and enforcement mechanism is necessary in order to ensure full compliance of CRAs with all the stipulations of the IOSCO Code.

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On behalf of the German insurance industry, we would like to thank CESR for the opportunity to submit our comments on the consultation paper "The role of credit rating agencies in structured finance" published on 13th February 2008. As the trade association of the German insurance industry with almost universal membership, the GDV represents 455 insurance companies (life, health, property/casualty and reinsurance) with total assets of some EUR 1.2 bn. German insurers use external credit ratings extensively, both in their role as institutional investors and as issuers in the financial markets. In addition, CRAs' ratings are an important element of insurance supervision, and they are also increasingly relied upon by insurance customers. Therefore, the insurance industry depends crucially on high standards in the rating process and on the reliability and quality of the ratings issued by CRAs.

We were in full support of the creation of the current regulatory regime for CRAs with the publication of the IOSCO Code of Conduct Fundamentals in 2004 and the establishment of CESR's monitoring framework for CRAs' activities in the European Union in 2006. We appreciate the valuable work undertaken by CESR in this field over the last years, and we welcome CESR's efforts to further improve the regulatory framework for CRAs in light of the experience with the current system.

In commenting on CESR's consultation paper, we would also like to provide some general assessment on the success of the current regime. We believe that it is important that the question of the appropriate regulatory regime for CRAs should be decided on the broadest possible basis, taking into account the whole range of CRAs' activities, both ratings of structured finance products and traditional corporate ratings, but also special types of ratings that can be of great importance in individual market segments, e.g. insurer financial strength ratings. We therefore appreciate that CESR has included in its consultation paper an "update" on several aspects from its first report on CRAs' compliance with the IOSCO Code in 2007 – in particular the analysis of subsequent changes to CRAs' codes of conduct – and that CESR in its "conclusive considerations" discusses the question of further regulatory measures in general terms.

Assessment of current regulatory framework

In our view, the IOSCO Code complemented by the monitoring and reporting function which has been assigned to CESR by the European Commission can be regarded as a major step towards closing the regulatory gap which had previously existed in the market for credit ratings in the European Union. It is our experience from the German insurance market that as a consequence of the new regulatory regime there have been significant improvements in CRAs' business conduct, e.g. with respect to transparency of methodology and interaction with market participants. However, there are still some shortcomings, and further adjustments in the

regulatory framework are required. In our response to CESR's earlier questionnaire from 2006 on the day-to-day application of the IOSCO Code by CRAs we already provided extensive evidence from the German insurance market – including evidence from two interactions between the GDV and Fitch – which showed both the effectiveness but also the shortcomings of the current regime.[1] In particular, one important area in which full compliance with the IOSCO Code has not been achieved in the German insurance market is the disclosure of unsolicited ratings. In 2006 we suggested that the IOSCO Code might need some clarification, and we also proposed the creation of an arbitration mechanism in case of disagreement between market participants and CRAs over the interpretation of the Code, as was partly the case in the dispute between the GDV and Fitch.

Developments since 2006 have confirmed our earlier assessment. CESR's 2007 report to the European Commission and its dialogue with CRAs together with continued market pressure have led to further progress in CRAs' codes of conduct and practices. However, as the analysis of the changes to CRAs' codes since CESR's 2007 report included in the consultation paper clearly shows, so far these changes have not dealt sufficiently with all issues of concern. For example, there have been no policy changes to guarantee sufficient disclosure of unsolicited ratings. What is more, recent turbulences in the markets for structured finance products have highlighted a number of additional areas in which the current regulatory regime requires substantial improvement.

From the point of view of the German insurance industry, the key issues of concern with respect to CRAs' activities in the field of structured finance are basically identical to the concerns regarding "traditional" rating activities, even though there might be some need for special provisions to take account of the particularities of ratings in structured finance. In particular, sufficient transparency of methodology and disclosure of the character of the rating – including its limitations – must be ensured, integrity of the rating process must be maintained, resources and staff qualification levels have to be adequate at all times, and conflicts of interest have to be avoided, or if inevitable, they have to be managed properly, maybe including a ban on certain activities by CRAs. We believe that in all of these areas there is scope for improvement. A strengthening of the regulatory framework is necessary in order to ensure that CRAs can fulfil their role in the financial markets and if distortions both in the market for ratings and in the financial markets are to be avoided.

For instance, it is essential that rating users have access to sufficient information on rating methodologies, e.g. on key model assumptions that

[1] Our response from 2006 is available on CESR's website: http://www.cesr.eu/index.php?page=response_details&c_id=75&r_id=3177. Further details on the interactions between the GDV and Fitch are provided on the GDV's website (introduction of Q-ratings for German insurers in 2004/2005: www.gdv.de/fitch-q-rating); GDV's letter of complaint to Fitch of 2006: www.gdv.de/fitch-gdv-complaint).

might differ from their own assessment or on changes in methodology so that it is possible to differentiate between rating changes that are due to a change in methodology and rating changes resulting from changes in underlying credit quality. Together with clear information on the type of rating (participation and initiation status, but also particular limitations of a rating) this would put investors in a position to fully assess the quality of a rating and its reliance for their investment decisions. Even though there have been significant improvements, and in many cases excellent information is provided by CRAs, so far, sufficient information is not always easily available. Another important example is human resources. It is of utmost importance that sufficient numbers of experienced staff are available at CRAs to maintain the quality of ratings and to allow regular monitoring of ratings and timely rating revisions in case of a change in credit quality. Although we believe that CRAs make great efforts to ensure sufficient staff levels, our experience is that especially in market segments in which there is a rapid expansion of rating activities, shortages in experienced staff occur that are sometimes not easy to resolve.

Considerations on the appropriate regulatory regime for CRAs in the European Union

In addition to the general assessment provided so far, we would also like to comment in more detail on CESR's conclusive considerations and the corresponding questions to market participants (part IV of the consultation paper).

164. Do you agree with CESR's view of the benefits and costs of the current regime?

Overall, we are very much in accordance with CESR's assessment of the benefits and costs of the current self-regulatory framework. In our view, the most important advantages of the current framework are its high degree of flexibility, its cost effectiveness and the international approach as the IOSCO Code provides globally recognised minimum standards.

In our view, however, one additional aspect that might be highlighted in addition to the draft provided in CESR's consultation paper is the important role of supervisory authorities in the current self-regulatory framework. Market forces alone could not be relied upon if satisfactory results were to be achieved because of a number of market imperfections in the ratings market. We believe that the current success of a self-regulatory framework is mainly due to complementary (informal) supervisory oversight. In our opinion, the high level of attention paid by regulators and supervisors world-wide to CRAs' activities has been essential for the effectiveness of the self-regulatory framework. The minimum standards incorporated into the IOSCO Code have been developed by supervisory authorities, and supervisory authorities' monitoring of compliance with these standards

and their reporting on CRAs' activities provide valuable information for market participants so that market forces can work more effectively.

What is more, powerful incentives for the CRAs to comply with the voluntary provisions of a self-regulatory framework and to maintain high standards are created by the threat of further regulatory action should the self-regulatory framework not achieve its objectives.

In our view, the most important shortcoming of the current system is that there is no arbitration or enforcement mechanism to guarantee compliance with the IOSCO provisions. Though in many cases market pressure and moral suasion by supervisory authorities is sufficient for CRAs to amend their practices this is not always the case. Under the current regime, even when there is a broad consensus among market participants and supervisors that a CRA violates a certain Code provision and, moreover, there is ample evidence that the Code's objectives are not achieved by the respective CRA, there is no way to force this CRA, which might insist on a different interpretation of the provision in the IOSCO Code or claim to exercise a legitimate right to deviate from the Code, to change its approach. This problem is aggravated by the oligopolistic market structure, which means that market participants are often not in a position to switch to other providers of rating services. It is this oligopolistic market structure which together with a multitude of informational asymmetries, is one of the most important arguments why the business conduct of CRAs cannot be left to market forces. However, on the other hand, the oligopolistic market structure could also be an advantage because it means that there is only a small number of important players that have to be fully committed to the self-regulatory framework to make it work. In this respect, the creation of an industry body representing CRAs that can make binding commitments for its members as proposed by CESR could play an important role in strengthening self-regulation.

170. Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

In general, here too, we agree with CESR's assessment. In our view, the most important advantage of a formal regulatory framework would be the possibility of strict enforcement of CRAs' compliance with the minimum standards. However, the exact benefits and costs of formal regulatory action very much depend on the exact regulatory design and also on the consistency of the European approach with international developments. In particular, there is a risk that if formal regulatory action on CRAs is not consistent across major financial markets, including the U.S. market, distortions and negative setbacks for areas with a regulatory approach that is considered an obstacle to their business conduct by major CRAs can result as a consequence of this regulation.

Moreover, any formal regulatory framework would also have its limitations. Due to the complexity and rapid development of financial markets and rating activities, supervisory authorities – as well as market participants or CRAs – might not always be in a position to adequately judge on the optimal design of minimum standards or the most appropriate interpretation of a stipulation. Therefore, a formal regulatory system would also have to rely heavily on constant monitoring by supervisory authorities and on periodic reviews of its provisions.

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

In our view, a pragmatic approach should be adopted. We believe that the most important measure with respect to improving the current regulatory regime would be an amendment of the IOSCO Code. Currently, many provisions of the Code contain general guidelines only and the wording is often ambiguous. To the extent that the Code provisions have proved insufficient or not clear enough, alterations are needed to reduce the scope of interpretation and to include additional aspects that have been identified in the meantime as being vital for the quality of the ratings. In addition to provisions with respect to the special demands of ratings of structured finance products an amendment should, in particular, also include a clarification of the provision on the disclosure of the type of rating that requires unequivocal disclosure of initiation and participation status at any time a rating is published. For the German insurance industry, the issue of disclosure of the type of rating is of particularly high importance since unsolicited and mostly non-participating ratings are widespread in the German insurance market. Indeed, for German insurers, the number of unsolicited ratings even exceeds the number of solicited, fully interactive ratings. Therefore, full disclosure on initiation and participation status of a rating is essential in order to avoid distortions both in the German insurance market and in the market for ratings.

A major shortcoming of the current self-regulatory framework is that cases of disagreement between market participants and CRAs or between supervisory authorities and CRAs over the interpretation of the IOSCO Code cannot always be resolved. In our view, market pressure and a monitoring function by supervisory authorities are not sufficient to guarantee that the objectives of the IOSCO Code are always achieved. Therefore, in order to further enhance CRAs' adherence to the Code in the sense that ambiguities cannot be exploited by CRAs or that CRAs cannot claim that they comply while in fact their business conduct is in contrast to the Code, some arbitration and enforcement procedure is required. The need for an arbitration mechanism has, for example, become apparent in the mentioned dispute between the GDV and Fitch which included a contradictory interpretation of the Code provision on the disclosure of the type of rating. With respect to the disclosure of unsolicited ratings, neither market pres-

sure nor statements by regulatory authorities (for example in CESR's 2007 report) have so far proved sufficient to induce this particular CRA or other CRAs to change their interpretation of the IOSCO Code.

There would be various possibilities to create an arbitration mechanism. For example, it might be possible to charge the same body at IOSCO that has drafted the Code and is currently working on its amendment with resolving arbitration appeals. Alternatively, this task could explicitly be assigned to supervisory authorities in the respective countries or regions (CESR in Europe). Another alternative would be the creation of a special committee for this task that consists of representatives from supervisory authorities, CRAs and market participants. An industry body representing CRAs could also play a major part in arbitration, but it would probably not be in a position by itself to provide unbiased solutions in cases of dispute between CRAs and market participants.

An arbitration body could be created as an extension of the current self-regulatory framework as long as there is a clear commitment by CRAs to respect its decisions and change their practices accordingly. Alternatively, a more formal regulatory framework might also be an option and should not be dismissed easily as long as the success of an extended self-regulatory approach is not evident. However, as in other areas, a careful analysis of all the costs and benefits of any formal regulatory action would be essential, and excessive regulation has to be avoided.

In any case, with respect to regulatory action in the European Union, a close co-operation between CESR, IOSCO, the SEC and national supervisory authorities in other countries is vital to ensure that an internationally consistent approach is taken. In addition, with respect to all regulatory activities concerning CRAs it is essential that there is a close co-operation between CESR, CEBS and CEIOPS in order to achieve consistency across all fields of European legislation and supervisory practice (e.g. regarding definitions and requirements for ratings used in prudential regulation). Furthermore, CESR's monitoring of developments in the rating business and regular reviews of the regulatory framework for CRAs remain essential as further changes in the regulatory regime might prove necessary in the future.

Berlin, 31st March 2008