



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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via Email

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Questionnaire on the day-to-day application of the IOSCO Code by the Credit Rating Agencies

Response by EFFAS – European Federation of Financial Analysts Societies

Dear Mr Demarigny,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 24 member societies representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management, Investment Advice.

Financial research is subject to regulation under the Market Abuse Directive 2003/6/EC and the Directive 2003/125/EC as well as under the Markets in Financial Instruments Directive 2004/39/EC. In Germany, section 34b Securities Trading Act (Wertpapierhandelsgesetz - WpHG) requires the observance of standards of professional training and qualification, appropriate identification of the person responsible and organisational measures to minimise conflicts of interests. The financial research industry has further adopted, on a voluntary basis, conduct of business rules specifying and supplementing the legal framework to ensure a high standard of care and impartiality.

In contrast to financial analysts, the Credit Rating Agencies (CRAs) do not directly present investment recommendations, but give opinions on the creditworthiness of companies, including issuers of financial instruments. As CRAs are usually granted access to confidential information, and since the credit rating has itself a substantial impact on the evaluation of an issuer, the CRA's rating assessment forms an important element in the investment research process and is usually considered by the financial analysts when preparing an investment recommendation. Given this background, we have been repeatedly approached by CESR and national regulators regarding the question of whether, and to what extent a regulation of CRAs may be required.

1. Do you know of cases where the methodologies used by CRAs were not consistently applied or where changes of methodologies were not clearly explained and disclosed?

Response to Question 1:

An example for a change of methodologies is the evaluation of pension liabilities by Standard & Poor's Ratings Services (S & P) in 2003 which resulted in a downgrading of the rating of leading German companies such as Thyssen Krupp AG, Deutsche Post AG and Linde AG. An expert's opinion subsequently prepared by Gerke and Pellens (*Pensionsrückstellungen, Pensionsfonds und das Rating von Unternehmen eine kritische Analyse*) revealed that S&P had changed its methodology in assessing the risks inherent in pension liabilities. S & P now included the pension liabilities in the calculation of the key figures. According to Gerke and Pellens, this practice of rating did not appropriately consider the different modes of financing of pension liabilities and the respective accounting in the balance sheet. Whereas companies from Anglo-Saxon countries usually do not show their pension liabilities in the balance sheet, because they have outsourced their pension liabilities to pension funds which they undertook to finance, it is common in Europe that a company creates a specific provision to account for its pension liabilities and therefore keeps them on its balance sheet. As the exposure resulting from the pension liabilities is economically the same in either alternative, it is not justified to apply a different methodology of rating simply because a company decides to take its pension liabilities off balance or not. Nevertheless S & P did not readjust its methodology. The rating does not therefore reflect the different alternatives for the accounting of pension liabilities appropriately, which exacerbates the comparableness of the rating on an international level.

Another example one may mention in this context is the Q-rating methodology applied by Fitch Ratings (Fitch) when performing unsolicited ratings of German insurance companies. This methodology was considered not to be transparent.

2. Do you know of ratings based on inaccurate information or issued without the credit rating agency having taken into account all relevant information?

Response to Question 2:

In connection with unsolicited ratings Fitch was criticised by the association of German insurance companies because its ratings allegedly suffered from analytical shortcomings. Among other things, the criticism related to the calculation of the capitalisation of German life insurers, due to incorrect addition of balance sheet items and the quantification of the mortality risk.

- 3.1 Do you consider that the CRAs devote sufficient resources to assign high quality credit ratings?

Response to Question 3.1:

The key factors to achieve a high standard of credit rating are human resources and the skills of the staff employed. The professional background and qualification of the CRAs' employees is not published. A framework of statutory rules requiring and detailing a specific professional standard of training does not exist. It is therefore difficult if not

impossible for a market participant to assess whether the resources employed by the CRAs are sufficient.

3.2. Do you consider that the CRAs devote sufficient resources to assign high quality credit ratings of structured finance instruments and to monitor them on an on going basis?

Response to Question 3.2:

The structured finance market is a relatively new market. The enormous dynamic development in this market and the complexity of structured finance instruments require special qualification to evaluate these instruments in a rating context. This is particularly true as market participants more often rely on the credit rating assessments than on context with other financings. However, this only underlines the responsibility of the CRAs and the need for a high standard of qualification of the CRAs' employees. Therefore, the answer given to questions 3.1 applies accordingly.

4. Do you consider that the period of time during which the rating decisions, the rating reports and the updates are publicly available is sufficient?

Response to Question 4:

A rating should be updated on an ongoing basis (see section 1.9 of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies). In order to meet the needs of the market participants, an update is required whenever new circumstances arise that affect the creditworthiness of an issuer. As rating companies use a "through the cycle-approach", they do not comment on every single market movement in an extra report which, as the case may be, can cause some delay.

5. It is always clear to you which are the critical elements underlying the rating decision (including its updates)?

Response to Question 5:

Critical aspects are mentioned in the rating report (and are part of the summary), but are often vaguely expressed. This may be due to confidential information which must not be disclosed as a matter of course. So, some always remains uncertainty about the underlying facts.

6. Do you think that the ongoing surveillance of CRAs on ratings, which can result in a rating action, is effective and timely?

Response to Question 6:

The present surveillance of CRAs ratings, which consists of a voluntary submission under the IOSCO Statement of Principles and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, only provides a framework of substantive rules, but no procedures and authorities are in place to effectively enforce compliance with these rules. Private law

instruments are limited because according to a recent judgement of the Court of Appeals of Berlin of 12 May 2006, a CRA can only be held liable for a rating if false statements of facts are disseminated such as have a negative impact on an issuer. The CRAs are granted a considerable discretion by the courts on how they prepare and present their findings. Further, the idea of market incentives, as a means to ensure a certain standard of rating quality, is illusory, since competition among the CRAs hardly exists.

Above the level of small and mid cap companies, the rating market is characterised by the existence of an oligopoly of the three leading CRAs, Moody's, S&P and Fitch.

7. Have you ever experienced (or heard about) situations where the CRA or its employees have given any assurance or guarantee of a particular rating prior to a rating assessment?

Response to Question 7:

We do not have knowledge of such a case. We would like to point out in this context, though that very concrete regulation has been established on conflicts of interest in the Market Abuse Directive (MAD).

8.1 Do you consider that the CRAs disclose clearly in the rating decision whether
a) the rating was not initiated at the issuers request?
b) the issuer has not participated in the rating process?

Response to Question 8.1:

According to our information, several German insurance companies objected to ratings being published by Fitch Rating because it failed to disclose that these ratings were unsolicited and have been made without the participation of the issuers rated (see question 15 below).

8.2 Is the above mentioned disclosure valuable for you?

Response to Question 8.2:

The disclosure of the background of the rating is helpful for the market participants to appraise the value of the rating reports. If an issuer does not participate in the rating process, the CRA does not have access to all information that may be relevant for a thorough analysis. This is particularly true in respect of such financial data which can only be gathered from internal accounting records. For the same reason, it is important to know whether the rating was initiated at the issuer's request. A solicited CRA would rather keep confidential the information it receives. One may therefore presume that a solicited CRA is better informed.

8.3 Do you know of cases where ratings of the type mentioned above (a and b) had a lower degree of quality than others?

No Response.

9. Have you ever experienced (or heard about) situations where the CRA has denied the issuer the opportunity to clarify any likely factual misperceptions or other matters that the CRA should be aware of prior to issuing or revising the rating?

Response to Question 9:

In the mentioned case where a number of German insurance companies objected to unsolicited ratings published by Fitch, one of the reasons for the complaints was that the insurers alleged they had not been informed of critical circumstances and denied an opportunity to clarify the factual misperceptions. According to the insurers, Fitch confronted them with its findings on such short notice of only a few hours that they did not have the time to react effectively.

10. Are you aware of cases where the rating decision was influenced by pressures from the issuers or other parties?

No Response.

11.1 Do you consider that CRAs have put in place adequate separations and firewalls between credit rating analysts and staff involved in providing other businesses (such as rating advisory, consulting, credit assessment, research)?

Response to Question 11.1:

The IOSCO Statement of Principles and the Code of Conduct Fundamentals provide for an obligation on the part of the CRAs to avoid conflicts of interests and to establish an organisation with adequate internal procedures and responsibilities to exclude or disclose potential conflicts of interests. We do not know, however, whether the CRA adhere to these provisions in practice.

11.2 Have you ever been in contact with credit rating analysts for other services than the one they provide within the context of credit rating?

Response to Question 11.2:

We have no information in that respect of individual employees of CRAs. As for CRAs as companies, as per our information, e. g. S & P offers investment research on stocks as a business.

12. As an issuer, have you ever negotiated the fees of the rating service with analysts involved in the rating process?

No Response.

13. Have you experienced any situation where the rating disclosure was not done in a timely manner?

No Response.

14. Have you encountered any problems in relation to the use of confidential information in your day-to-day business with CRAs?

No Response.

15. Do you know of cases where the credit rating agencies are not applying the provisions of their own codes of conduct?

Response to Question 15:

Some insurance companies that were rated by Fitch have blamed it for having repeatedly violated the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies and filed a complaint with IOSCO in April 2006. Fitch allegedly did not adhere to the provisions of section 3.9 (disclosure whether or not the issuers rated have requested and participated in the rating), section 3.7 (obligation to confront the issuer with critical information and to grant an opportunity to clarify likely factual misperceptions) and section 1.1 (thorough analysis of all relevant facts). The controversy has proved that different interpretations of the obligations under the Code of Conduct Fundamentals for Credit Rating Agencies may be possible. For the time being there does not exist any official procedure to enforce a unitary interpretation of its terms.

16. Are there any other comments you would like to make?

Response to Question 16:

Given the importance of credit ratings for both issuers and market participants, we believe that credit rating should be regulated to the same extent as financial research is regulated. The regulation should particularly include the observance of minimum requirements regarding transparency of rating methodologies, so the market participants can better appraise the value of the rating. For the time being, no unitary standard exists for the CRAs' rating practice. The IOSCO Statement of Principles and the Code of Conduct Fundamentals only provide a voluntary framework which the CRAs can adopt in their own codes of conduct. This is not sufficient. We suggest that unitary minimum standards are put in place. The Society of Investment Professionals in Germany (DVFA) has established an independent commission for rating standards with the function of developing and promoting rating standards. An example could be the DVFA Rating Standards (Updated version August 2006), which are attached.

Yours sincerely,



Fritz H. Rau
Chairman of EFFAS

DVFA Rating Standards

– transparency for company ratings –

A Objective

The sustained expansion and growing internationalization of the financial markets has given rise over the past several years to a major increase in demand among market participants for company assessment benchmarks that are both comparable and concise. Additionally, a varied range of external rating services has developed since the adoption and publication of the final Basel II framework – International Convergence of Capital Measurement and Capital Standards – by the Basel Committee on Banking Supervision in June 2004, and the respective drafts published since 2001.

In response to all this, the Society of Investment Professionals in Germany (*Deutsche Vereinigung für Finanzanalyse und Asset Managment* – DVFA) set out to develop standards that would allow an evaluation of the various rating models. To this end, DVFA established the Rating Standards Committee in 2000, under the chairmanship of Prof. Dr. Jens Leker (University of Münster). For the development of the Rating Standards, the committee created four expert groups, led by Prof. Dr. Dr. h.c. Jörg Baetge (University of Münster), Prof. Dr. Harald Krehl (DATEV eG), Dieter Pape (URA Unternehmens Ratingagentur AG) and Prof. Dr. Heinrich Rommelfanger (University of Frankfurt). The committee also includes representatives of various rating agencies, banking institutions, investment companies, audit firms, consulting houses and universities.

In 2001, the committee published its initial results in the form of the DVFA Rating Standards (FinanzBetrieb, 2001, Issue 4). In reaction to the strengthening trends on capital markets internationally and the final version of Basel II, the Rating Standards Committee has now “internationalized” the DVFA Rating Standards, and adapted them to the new Basel II framework.

The Rating Standards presently cover only fundamental issues relating to company ratings, as well as the input, throughput and output phases of the rating process.

The committee does not aim to evaluate the models used to produce the external ratings available on the market or the internal ratings used by banks. Rather, its objective is to provide a communication platform for all those involved in the rating process and interested members of the professional public. The Rating Standards are designed to improve transparency and the informational basis for critical evaluation of rating models by financial market participants and regulatory agencies.

They are presented as a catalogue of questions and answers to facilitate evaluation of the methods and results of the rating models under consideration. Their acceptance will be assured through integration of specific expertise gleaned from financial market participants and institutions.

B Definitions

1 Company rating

The term “rating” refers generally to methods for assessing certain criteria based on specific categories and assigning them a ranking. The rating models currently available on the market cover various types of ratings, such as: the issuer credit rating, the credit rating of individual financial instruments, client and supplier credit ratings or the equity rating.

The committee has limited the scope of the Rating Standards to the credit rating, as an indicator of the creditworthiness or earnings power of a company. The credit rating represents a comprehensive analysis of a company, incorporating all available relevant information, with the purpose of assessing the probability of default as defined below.

2 Default

A uniform definition of “default” is necessary as the basis for comparable default probability indicators. The new Basel Capital Accord proposes the following reference definition¹:

A default is considered to have occurred with regard to a particular obligor when either **or both** of the two following events have taken place:

- The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security (if held).
- The obligor is past due more than 90 days on any material credit obligation to the banking group.⁸² Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.

¹ cf. International Convergence of Capital Measurement and Capital Standards – A Revised Framework (margin number 452-453), Basel Committee on Banking Supervision, June 2004, as translated by *Deutsche Bundesbank*.

The elements to be taken as indications of imminent illiquidity:

- The bank puts the credit obligation on non-accrued status.
- The bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure.
- The bank sells the credit obligation at a material credit-related economic loss.
- The bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees.
- The bank has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group.
- The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group.

C Questions

1 General information about the rating

1.1 Description of the rating approach

1.1.1 Purpose of the rating agency

What purpose is being pursued by the rating agency?

Is rating among the primary business areas of the agency?

A differentiation may be made between internal and external rating:

- External rating: Generally, rating is the primary business of the rating agency, which offers the service as a product to other market participants.
- Internal rating: Rating serves company management purposes, and is not the primary business of the agency. Rating is not offered to external market participants, but rather serves to increase the transparency of internal rating assessments.

1.1.2 Rating purpose

For what purpose was the rating prepared?

A differentiation may be made between the following rating purposes:

- Improved refinancing of listed and private companies via the capital market,
- Basis for the structuring of private contractual relationships,
- Prerequisite for public or private contracting,
- Collection of information before entering into individual business relationships, or
- Critical assessment of own business operations.

1.1.3 Rating process

What are the defined phases of the rating process?

In this context, rating processes may be broken down as follows:

- Few phases to none (data collection, data analysis) or
- Detailed architecture (preliminary planning, contract signing, data collection, data analysis, rating result, rating publication).

1.1.4 Informational basis of the rating system

On what types of information is the rating system generally based?

A differentiation can be made between the following quantitative and qualitative information:

- External accounting data concerning the rated company on the basis of the balance sheet and income statement,
- Supplementary external accounting data concerning the rated company (notes, management report, voluntary reporting),
- Reference data concerning other companies, sector data, competition data, trend and risk data for the sector, fundamental economic data,
- Qualitative data concerning primary and secondary value chains, management quality and company culture of the rated company, or
- Results of non-specific external ratings (e.g. company or sector ratings, etc.).

1.1.4.1 Sources of information

Which sources are used to gather the information on which the rating system is based?

Potential sources of information are internal and external accounting, company employees, suppliers, clients and other business partners of the rated company, as

well as third-party information providers (e.g. external rating agencies, analysts, commercial credit reporting agencies).

1.1.4.2 Data time horizon

What is the time horizon of the input data?

The data may include:

- Preceding year's data,
- Historical data,
- Historical time series, or
- Projection for the near future based on forecasts by the rated company and the rating agency.

1.1.4.3 Data collection method

How was the data collected?

To what extent are the rating agency and the rated company involved in the rating process?

The data may be collected as follows:

- Primary data collection directly at the rated company by the rating agency's own analysts,
- Secondary data collection via analysis of data provided by the rated company, or
- Combination of primary and secondary data collection.

With respect to involvement in the rating process, the following scenarios are possible:

- The rated company is not involved in the rating process, or
- The rated company is actively involved in the collection of information.

How is this data validated by the rating agency?

The data may be validated by way of:

- Comparison with internal reference data (e.g. accounting data, employee surveys), or
- Comparison with external reference data (e.g. analysts' information).

1.1.5 Rating method

Which methods are used to consolidate the information about the rated company into a uniform rating result?

How are the criteria selected (selection of criteria), defined (definition of criteria) and aggregated (consolidation and weighting of the criteria)?

In general, the following scenarios are possible with respect to rating methods:

- Criteria selection, definition and aggregation are achieved using a mathematical-statistical model.
- Criteria are selected by experts; criteria are defined and aggregated using a mathematical-statistical model.
- Criteria selection and definition is the work of experts; aggregation uses a mathematical-statistical model.
- Criteria selection, definition and aggregation are performed by experts.

1.1.6 Quality assurance by the rating agency

Which structural and organizational principles are followed by the rating system?

Is the four-eyes principle upheld?

Is there a segregation of data collection and data analysis?

Are comparisons made with external rating systems?

Which other quality assurance measures are employed?

The following are possible quality assurance measures:

- All phases of the rating process, from data collection to communication of the final rating are subject to an internal control system (ICS), Particular

care is taken to observe the principle of segregation of functions and the four-eyes principle,

- Feedback from the rating results end of the process to the data collection end as a way of influencing results is prevented (no adjustment in the event of unfavorable results),
- To the extent possible, rating results are externally compared to the results arrived at by other rating systems, or
- A plausibility check is in place.

1.1.7 Rating result

1.1.7.1 Rating scale

Is a scale employed to classify the rating result?

Can the scale used be mapped to a master scale?

What historical default rates are associated with the individual rating classes on the employed scale?

The following scenarios are possible for exhibiting the rating result:

- An internationally recognized rating scale is used, which can be mapped to a master scale,
- An individual rating scale is used; results are mapped to a master scale, and this is presented as well, or
- An individual rating scale is used, which cannot be mapped to a master scale.

Every rating result based on a rating scale should include:

- The name of the rating class and the associated default rates (in %), and
- The data basis and time horizon.

1.1.7.2 Publication

How is the rating result published?

Publication of the rating must be suited to the rating purpose.

Rating agencies should publish a report in accordance with generally accepted reporting principles. These reports should allow a comparison of track records between various rating agencies. Rating agencies should state whether:

- Rating results are normally published,
- Rating results are only published if desired or permitted by the rated company,
- Rating results are used only for the management purposes of the rated company, and not published.

1.2 Description of the business relationship between the rating agency and the rated company

1.2.1 Independence of the rating agency from the rated company

Is the rating agency independent of the rated company?

Ratings should be independent of the company's business interests. Independence of the rating agency means that no rating agent should simultaneously perform a consulting function for the rated company. The results by the rating agency should not be subject to political or economic pressure. The rating process should not be burdened by conflicts of interest arising from the management and/or partnership structure of the rating agency. As a rule, rating agencies should not provide buy/sell recommendations, market price assessments, or recommendations on the suitability of an investment for a specific investor.

1.2.2 Obligation of the rating entity to comply with ethical standards

To what extent is the rating agency subject to ethical standards?

Ethical standards apply to institutions, such as rating agencies, as well as natural persons, such as rating experts, credit analysts and other rating professionals. Their

activities must be in line with statutory guidelines, in particular relevant European and German capital market legislation, as well as with the ethical principles applicable to academic professions in Germany and related international rules for the profession.

Adherence to ethical standards should be documented at institutional and personal level on the basis of at least the following catalogue of basic principles for ethical professional conduct:

- Proof of professional and ethical qualifications,
- Observance of the latest professional and academic standards; regular re-qualification in the latest standards,
- Establishment of organizational structures to prevent conflicts of interest; obligation to obey compliance rules,
- Disclosure of potential conflicts of interest, in particular by way of commercial ties with the rated company, as well as other potential sources of conflict, which could threaten a fair and professional assessment,
- Respecting the incompatibility of rating and consulting activities, in particular the prohibition against representation of conflicting interests,
- Respecting the autonomy, independence, neutrality and impartiality of the rating experts as the basis for qualified assessment results,
- Final rating only after professional, thorough and precise application of rating methods,
- Disclosure of information relevant for an evaluation of the rating in accordance with the Rating Standards,
- Regular updating of the data pool and timely disclosure to the market of material changes to the rating result,
- Compliance with due diligence obligations in data collection and processing, as well as for release of the information,

- Observance of the prohibition against publication of inaccurate or incomplete information, or the omission of material facts that could effect the rating result; inadvertent errors must be publicly corrected immediately after they are identified.
- Observance of the obligations to secrecy and confidentiality,
- Avoidance of illegal business practices, in particular violations of insider legislation and active corruption, and
- Observance of copyright protections and the prohibition against plagiarism.

1.2.3 Applicability of the terms and conditions of the rating agency

To what extent are the terms and conditions of the rating agency applicable?

The terms and conditions of business should be a component of the agreement between the rating agency and the rated company.

1.2.4 Designation of specific contacts

Are there persons within the rating agency designated as specific contacts in connection with the rating result?

The rating agency should designate the authors or producers of the study that will be available to the rated company in connection with rating issues.

1.2.5 Ensuring complete information and authorized sources

Are there measures in place to ensure that the management and designated sources at the rated company immediately forward all relevant information to the analyst team at the rating agency?

Have the designated sources and legal representatives been informed of the type and scope of information required by the rating agency?

The following are possible measures to ensure that all known or latent risks are recognized in the rating process:

- All relevant information is collected in the rating process; no separate research is required.
- The type and scope of the information required by the rating agency is defined in the rating agreement, and the legal representatives of the rating agency are obliged to make this information available by virtue of their signatures.
- At the end of the data collection phase, a declaration is obtained from the legal representatives that the analysts were provided with all relevant information, in order to validate the findings. This declaration is usually in the form of a checklist, contains the names of those designated as sources and is signed by the legal representatives.

Example:

Data on current or latent risks (process, liability, guarantee risks, etc.) of the rating agency have not yet been made available, or were first identified during the rating process. For instance:

- Key patent rights can be challenged by third parties or used without authorization,
- Recent studies reveal that certain substances used by the company could pose health risks, or
- Key suppliers may soon be facing delivery problems that cannot be compensated for through inventories or alternative suppliers.

1.3 Structural independence

Is the rating agent independent of the rating agency?

Is the quality assurance agent independent of the rating agent?

Is the rating result independent of downstream decisions?

see Item 1.2.2

2 Informational basis of the rating result arrived at by the rating agency

2.1 Evaluation of input data quality

2.1.1 Criteria selection

What is the basis for criteria selection?

Criteria may be selected on an individual, case-to-case, or systematic basis, or on the basis of a statistical distribution model.

2.1.2 Data aggregation

To what extent has the available input data already been aggregated by the rated company?

Has data aggregation led to the loss of valuable information, distortions or errors?

Care must be taken to ensure that material information is neither lost nor distorted in the process of data aggregation. A differentiation should be made between cases in which ratings are based on raw data aggregation by:

- The rating agent, or
- The rated company.

2.1.3 Credibility

How credible is the internal and external input data?

- Planning and forecast data from the rated company are included.
- Third-party data (public and non-public institutions) is included.
- Unaudited annual financial statements, interim or preliminary financial statements prepared by the company are included.
- Audited financial statements are included.

2.1.4 Processing

How are missing data and information treated?

How are aberrations treated?

When using mathematical-statistical models, aberrations and missing values must be treated properly.

2.1.5 Consistency

How is data consistency evaluated?

The consistency of the actual data for the rated company should be evaluated, and measures or methods used for this evaluation should be disclosed by the rating agency.

2.1.6 Scaling

How is the input data scaled?

The input data may be scaled nominally, ordinally or metrically. The respective scaling requirements of the selected methods must be satisfied.

2.1.7 Internal control

How is the data input by the rating agency?

How are input errors avoided?

A description must be provided for the data collection process, the transfer of data to processing and the evaluation of data.

2.2 Information categories

What data does the rating system use?

An evaluation of rating quality requires insight into the informational basis available to the rating agency. The following is a checklist of potential information sources that can be used to rate a company.

2.2.1 Information on the identity of the rated company:

Is information included, e.g. concerning the legal form, locations, size and ownership structure of the company?

- *Company name*,
- *Legal form*,
- *Registered office and locations* (commercial registry, nationality, registered offices, locations),
- *Establishment date*,
- *Sector classification(s)* (sector identifier, regional focus of procurement, production and sales),
- *Company size criteria* based on disclosure and co-determination legislation (total assets, revenue, employees),
- *Group membership* (as controlling group parent, as dependent subsidiary),
- *Ownership structure* (sole proprietor, family business, public-sector enterprise, venture capital companies...), and
- *Historical company performance*..

2.2.2 Accounting data from the rated company

Is information, e.g. concerning type of financial statements, legal basis for accounting or relevant projections included?

- *Scope of accounting* (single-entity, group),
- *Legal basis for accounting* (HGB, IFRS, US-GAAP, tax laws, other local standards, type and timing of accounting transition),
- *Type of financial statements* (regular annual, interim, extraordinary),
- *Auditor's opinion/certification* (auditor's opinion (*Wirtschaftsprüfer*), certification by tax advisor (*Steuerberater*) involved in the audit, change of auditor/tax advisor),
- *Formal approval of the annual financial statements* (by supervisory board, by shareholders' meeting, jointly by management and supervisory boards, approval of annual financial statements),
- *Time frame* (number of financial years, gaps in the current financial year, interim period, shortened financial years),

- *Projected financial statements* including planning horizon (complete annual financial statements, projections of individual data / figures), and
- *other financial projections* including the planning horizon (revenue projections, material expenditure projections, financial plans, investment plans, projected cost of capital).

2.2.3 Non-financial indicators of company potential

Is the development of future markets and market position taken into account?

Are management quality, location and environmental considerations and personnel resources taken into account?

- *Market and market position of the rated company* (life cycle of the sector and products, cost structures of the sector and the rated company, concentration trends in the relevant markets, sector performance, barriers to market entry, market regulation, market shares, dependence on volume clients, quality and level of innovation of the products and product range, distribution capacity, etc.),
- *Production and procurement* (extent of vertical integration, dependence on specific technologies, inputs or raw materials, dependence on high-volume suppliers, relative cost advantages, dependence on bottleneck production factors, raw material and energy supply security,...),
- *Management* (size of upper management, supervisory board/council, areas of qualification, recruiting and fluctuation of upper management, dependence of the company on singular personalities, networking of upper management, incentive systems, strategic development and strategy communication, company culture, quality management, management information systems, organizational structures, informational policy of the company, risk management system),
- *Personnel* (personnel structure, dependence on key persons, personnel planning, development and recruitment), and

- *Location/environment* (stability of the political environment and legal system, economic development promotion, restrictions, conditions for public procurement, economic development of the location, infrastructure, environmental management).

2.2.4 Risk analysis and risk management

Are potential risks distinctively defined and systematically identified?

Are all individual risks identified and correctly aggregated to an overall risk indicator.

Is detailed information recorded on the effectiveness and efficiency of risk management?

- *Definition of potential risks* (operational risks, strategic risks, delineation of individual risk types),
- *Key individual risks* (risks from bottleneck factors, default risks with respect to receivables from customers, supply chain risks, product liability risks, currency and derivative risks, risks from existing debt, etc.),
- *Aggregation of individual risks* (qualitative risk aggregation using a risk matrix, statistical risk aggregation on the basis of a Monte Carlo Simulation), and
- *Aspects of risk management* (risk planning, instruments of risk management, organization of risk management, Expert opinions on risk management, organizational integration and responsibilities, existence of early warning systems).

2.2.5 Information on reference companies for evaluation of the rated company

Has dynamic or static benchmarking taken place?

Have sector and cross-sector comparisons been conducted?

Are other mathematical-statistical comparisons conducted?

- *Chronological comparison* (single year, multiple years),
- *Individual company comparison* (name of the reference company, size data, legal form, specific sector classifications, significant structural differences in comparison to the rated company, data basis),

- *Sector comparison* (specific sector classification, number of reference companies, averages, distribution values),
- *Cross-sector comparison* (subjective evaluation, empirical evaluation, historical insolvency rate in the sector), and
- *Non sector-specific comparison* (scope of reference samples, prices of the reference samples, reference period).

3 Information processing in the rating process

3.1 General criteria for the evaluation of rating system quality

3.1.1 Rating model

What combination of rating models does the rating agency apply in its rating system?

In general, a rating system comprises several components or rating models. In practice, other information is used as a basis to evaluate the result arrived at by a rating model in all cases, except those in which there is absolute certainty about the accuracy of the rating. In many cases, material creditworthiness is assessed initially using a mathematical-statistical model, and other factors are applied later with respect to management quality, sector situation and market positioning, etc., in order to assign a final rating classification. This may be the result of another procedure and/or an expert opinion.

3.1.2 Transparency and plausibility

Is the rating result based solely on transparent and plausible criteria?

Are the structures of the rating system presented in a way that a qualified third party would understand?

The rating agency must provide quantitative and qualitative information that serves to answer questions of transparency and plausibility.

3.1.3 Validity

Can the rating system produce an issuer rating?

In order to ensure the validity of the rating system, care must be taken to ensure that the rating result is actually a measure of the intended feature – in this case, the issuer rating. For detailed information on the validation of the rating model, see DVFA Rating Standard Validation

3.1.4 Accuracy

How high is the probability of error attributed to the rating system used?

Accuracy means that the final rating result correctly represents the creditworthiness of the company under consideration. The probability of error serves as a measure of accuracy – as expressed in the alpha/beta errors. The alpha error (type I error) represents the empirical probability that an insolvent company may erroneously be deemed “solvent”. The beta error (type II error) represents the empirical probability that a solvent company may erroneously be deemed “insolvent”. As a further measure of accuracy, so-called “power curves”, or the error band below the curves (Gini Coefficient), indicate the discriminatory power of the rating model.

3.1.5 Reliability

Does the rating system consistently return the same results based on the same input?

What is the extent of corroboration between various rating analysts at the same rating agency?

Do different rating agencies arrive at the same result?

A rating model is considered reliable when equivalent input data lead to the same rating result. This can be assured by:

- Reducing the freedom of discretion with respect to the evaluation of qualitative criteria, and
- Properly training staff.

In addition to evaluations of reliability, the sensitivity of the rating system to subjective expert opinions should also be analyzed.

3.1.6 Granularity

Is there an adequate number of rating classes available to satisfactorily differentiate the results?

The number of rating classes should be suitable in relation to the volume of input data and the degree of aggregation.

3.1.7 Clarity of the rating result and integrity of the required input data

Can every rated company be assigned to exactly one rating class?

It should be possible to prepare a rating for each company that permits clear assignment to a single rating class.

3.1.8 Currentness and robustness

How often is the rating system reviewed and, if necessary, updated?

What events trigger a review of the rating system?

Who is responsible for updating the rating system?

The rating system should be regularly reviewed to assess its suitability. In particular, it must be assured that material changes in fundamental economic data are addressed through prompt adjustments to the parameters of the rating model.

3.1.9 Relevance

Does the system use all information relevant for the assessment of the rated company's creditworthiness?

Information is deemed relevant if its omission would modify the rating result. As a rule, all information relevant for the analysis of creditworthiness should be used in the rating process.

3.1.10 Influence of the rated company

Do the sector affiliation, legal form, size or other characteristics of the rated company have a significant impact on the rating system?

How detailed is sector differentiation?

It should be clear whether or not sector affiliation, legal form, size or other specific characteristics of the rated company are taken into account for the assessment.

3.2 Criteria for evaluating the quality of empirical rating models

3.2.1 Data basis

Does the data basis satisfy the requirements of the model with respect to integrity and quality?

For the sample, elements (e.g. companies) must be obtained, whose rating classification (e.g. solvent - insolvent) is known. The grouping variable is scaled nominally.

The companies selected for the sample should be representative of the population as a whole. Although no generally applicable method is available to ensure a representative sample, the probability of meaningful conclusions should increase with the size of the sample.

It should be possible to divide the data basis into discrete groups based on significant criteria. Criteria are considered distinctive and therefore “significant” if the characteristics of the groups under consideration are materially dissimilar.

3.2.2 Criteria selection

Do the criteria selected satisfy the requirements of the model?

Depending on the specifications of the model, there are different requirements with respect to the characteristics of the criteria. In particular, the requirements as to the (stochastic) independence and scaling (nominal, ordinal, interval or ratio scaling) of the data must be satisfied.

3.2.3 Performance of the model

Does performance measurement satisfy the requirements of the model?

The number of explanatory variables or total forms thereof should not exceed a reasonable upper limit based on the scope of the training sample. The selection of explanatory variables should cover the most important aspects of the criteria area, and the correlation of the criteria variables should be held to a minimum.

In the case of key annual financial figures: in order to fully represent the information potential of the financial statements, the criteria (in this case, external accounting figures) should reflect several areas (net assets, financial position, operating results, etc.).

Estimation of model parameters
The estimation of model parameters should be based on a portion of the overall sample, known as the training sample. The training sample must represent the best possible cross-sample of current and future obligors.

The training sample must be large enough so that the classification of the training set provides a useful indication as to the classifications for the entire sample.

Care must be taken to ensure that the estimated parameters lend themselves to sound economic interpretation.

3.2.5 Performance of the model

In order to determine the classification performance of the rating model, the overall sample should be divided into at least one training and one holdout sample. The data from the companies included in the training sample serve to calibrate the model parameters. The holdout sample(s) serve(s) to validate the model (backtesting), and should include only those companies that have not already been included for model calibration. Statistical testing should be used to ensure that all samples represent discrete random sets from the overall sample, and the quality measure should be provided that permits evaluation of the rating model's discriminatory power.

3.3 Additional criteria for evaluation of individual rating models

3.3.1 Criteria for mathematical-statistical models

Does the estimation of model parameters satisfy the requirements of the mathematical-statistical model?

The estimation of parameters is often based on specific assumptions, which should be documented and binding. This is relevant, for instance, to assumptions about the distribution of explanatory variables, or to the mathematical requirements for the estimation procedure.

3.3.2 Criteria for scoring models

3.3.2.1 Defining the target system

Is information provided on the means of selecting individual factors?

Information should be provided on the selection of individual factors (subjective, statistical analysis).

3.3.2.2 Ranking of alternatives

Is information included on the methods used to determine the ranking of alternatives?

The range of the evaluation scale must suit the criterion being evaluated. However, the distance between the highest and lowest values on the scale does not have to be uniform for all targets. Points on the scale should be defined and depicted in such a way as to make the evaluation scale roughly metric. Information should be provided on the method used to select the criteria and to define their weighting (subjective, statistical analysis).

3.3.3 Criteria for expert systems

3.3.3.1 Knowledge base

What is the composition of the knowledge base?

About which categories can the knowledge base provide results?

From which sources was the available data collected?

The knowledge base may comprise:

- internal/external databases,
- (specific) expert observations, e.g. individual expert opinions concerning a certain segment of the company, or
- (standardized) expert experience that can be applied to the selection of criteria and definition of rating classes, or to the relevant aggregation operators or processing rules, etc..

Information should be made available on the qualifications (education, professional experience, references, obligation to comply with professional standards, etc.) of the experts involved in building the system. The expert knowledge applied must be documented in detail.

3.3.3.2 Oversight system

Which scaling requirements apply to the input data as a result of the aggregation method selected?

Are these requirements satisfied?

In the case of operation-based aggregation, metrically scaled input data should be available; for rule-based aggregation, ordinally scaled input data is sufficient.

Are linguistic evaluations of the criteria described adequately and clearly?

In the case of fuzzy logic-based systems, linguistic variables are described using fuzzy intervals represented by associative functions. The description should elaborate on the definition of the evaluation intervals, and indicate whether data information was used in addition to expert knowledge.

Is the evaluation process transparent?

The aggregation structure should be understandable to a knowledgeable third party. The aggregation operators and/or rule sets must be documented.

How often is the expert system reviewed and, if necessary, modified?

The events that trigger a review of the knowledge base and the experts involved in any modifications should be identified.

How long has the expert system been in use and how accurate have results been in the past?

The age of the expert system should be provided. For information on accuracy, see Item 3.1.4

3.3.4 Criteria for neural networks

3.3.4.1 Structure

What is the number of neurons in the input, hidden and output layers?

The number of neurons, hidden layers and connections should be indicated.

3.3.4.2 Training

Is information provided on training of the neural network?

Is information provided on the use of holdout samples?

Information should be provided on the computational algorithm used (supervised or unsupervised), as well as the pruning methods and the number of training runs. In addition, an indication should be made as to whether sensitivity analysis was used to monitor the influence of the input parameters.

The forecast results of the holdout sample should be used as a benchmark for the performance of the neural network. Validation should be based on a third, independent sample.

3.4 Criteria for evaluating qualitative rating models (classification by rating analysts based on a unspecified model)

3.4.1 Qualifications of the rating analysts

What information is provided in the qualifications and independence of the rating experts?

The rating agency should disclose its general (minimum) requirements and work standards for its analysts (education, training, experience, obligations to comply with professional standards, etc.).

3.4.2 Rating process

To what extent is the rating process standardized?

How detailed are the guidelines followed by the experts?

The rating process and the number of participating experts must be documented. Moreover, the requirements provided to the experts with respect to criteria selection and data currency should be stated, along with information on the extent to which benchmarks and knockout criteria are applied.

3.4.3 Rating quality assurance

How is the quality of the rating assured?

The conclusion arrived at by the expert(s) should be assessed by further persons. Compliance with the four-eyes principle and the existence of ongoing quality control measures should be documented.

4 Information on the rating result arrived at by the rating agency

4.1 General information on evaluation of the rating result

4.1.1 Comparability

Is mapping to a master scale possible?

If various rating scales from different rating agencies are used, it should be possible to represent each of these on a “generally accepted scale” (master scale), in the interest of comparability. This can only be achieved, however, on the basis of a uniform definition of “default”.

4.1.2 Transparency

The rating result must be transparent. The linkages between the selected criteria and the final result must be disclosed. This involves both public and individual disclosure, in order to allow proper interpretation of the rating result by the rated company and other financial market participants.

The rating must be transparently presented to the rated company individually, so that it can clearly understand the rating result. The rating result may not be amended after the fact, unless overt errors have been made in the rating process. Minutes should be kept of informational exchanges between the rating agency and the rated company.

External disclosure of the rating results depends on the rating purpose, especially as defined by the initiator of the rating, or its stated objective.

4.1.3 Monitoring

Does the rating agency regularly publish information concerning the quality of its rating results?

Monitoring and scrutiny of the rating results should primarily be a function of the market. To this end, the rating agency should regularly publish historical default rates for each rating class (track records). If mathematical-statistical models are used, information should be disclosed with respect to model significance, classification quality and monotonicity of the historical default data.

4.2 Information of the interpretability of the rating result

4.2.1 Individual information about the rating result

4.2.1.1 Company identity

What information is provided on the identity of the company?

see Item 2.2.1

4.2.1.2 Currency and date-marking of the rating result

Can the currency and date of the rating results be readily determined?

The date of the rating result and the time horizon of the input data should be indicated. Since a rating remains in effect until it is amended or withdrawn, the assessment of the rating agency should be subject to ingoing review, and immediately modified in accordance with any new information that impacts creditworthiness. All modifications of the rating result should be documented, and a history of the rating should be maintained.

The ratings should be amended with due promptness, immediately after the rating agency receives new information (quarterly or annual financial statements, ad hoc disclosures). Material changes to the creditworthiness of the rated company should result in prompt amendment of the rating.

4.2.1.3 Consideration of country risks

Information on sector or country-specific risks may be provided separately, or as an implicit component of the rating result.

4.2.1.4 Probability of default

Information should be provided as to the average probability of default for the rating class to which the company is assigned.

4.2.2 Rating scale

4.2.2.1 Description of the rating scale

Information should be provided about range and scaling, as well as mapping to a master scale.

4.2.2.2 Definition of default

“Default” should be defined in accordance with the Basel Capital Framework by the Basel Committee on Banking Supervision. Individual definitions that deviate from this must be explained in detail within their specific context, and should take account of partial default, loan restructuring, delay of payment and security pledged.

4.2.2.3 Probability of default in the individual rating classes

The mean probability of default and, to the extent possible, the intervals should be provided for each rating class.

4.2.3 Scope of the rating

4.2.3.1 Forecast horizon in years

A differentiation should be made between short-term (< 1 year) and long term (> 1 year) rating forecasts.

4.2.3.2 Sector

The relevant sector classification should be indicated, e.g. manufacturing, other industrials, banking/insurance, services, consumer goods, etc.).

4.2.3.3 Company size

Information about company size should be standardized in accordance with sections 267 and 293 of the German Commercial Code (HGB) and sections 1 and 11 of the Germany Disclosure Act (PublG).

4.2.3.4 Regional scope of application

To the extent possible, the rating should apply globally without limitations, but may be subject to local, national or international restrictions if there is good cause.

D Special Criteria for evaluating individual mathematical-statistical models

1 Criteria for linear discriminant analysis

1.1 Data basis (sample requirements)

Does the data basis satisfy the requirements of linear discriminant analysis?

Unmodified, this model is only suitable for use with metrically scaled input data. Nominally and ordinally scaled data should only be used if they can be mapped to a metric scale with sufficient accuracy.

1.2 Criteria selection and construction of the discriminant function

Do the criteria selected satisfy the requirements of the linear discriminant function?

In order to satisfy the theoretical requirements of linear discriminant analysis, the criteria selected for grouping should be normally distributed as far as possible, with identical variance-covariance matrices.

Is information provided on the form of the discriminant function?

If linear discriminant function analysis is selected as the methodological basis, the discriminant value Z is derived from the linear discriminant function to be determined with the discriminant function coefficient a_i and the explanatory variable KZ_i , in the general form: $Z = a_o + a_1 \cdot KZ_1 + a_2 \cdot KZ_2 + a_3 \cdot KZ_3 + \dots + a_n \cdot KZ_n$

1.3 Estimation of the discriminant function coefficients

Does the estimation of the model parameters satisfy the requirements of the linear discriminant function?

The estimation of the discriminant function coefficients should be based on a portion of the overall sample, known as the training sample. The training sample must represent the best possible cross-sample of current and future obligors. It must be of sufficient size that the classification of the training set provides a useful indication as to the classifications for the group containing the company under consideration. Care must be taken to ensure that the estimated parameters lend themselves to sound economic interpretation.

When evaluating the discriminant function coefficients, it must also be ensured that the associated coefficients, and thus the indicator combinations in a classification function, do not allow conflicting economic interpretation.

Freedom from conflicting economic interpretation means that criteria deemed positive from an economic standpoint are included in the computed classification function with a different mathematical sign than those deemed negative. A function that meets these requirements is considered consistent from an economic standpoint.

1.4 Performance measurement of the estimated discriminant functions

Does performance measurement satisfy the requirements of the linear discriminant function?

The quality measure used to evaluate the discriminant function should be indicated. A description of the correlation between the discriminant value Z and the rating class should also be provided.

2 Criteria for logistic regression

2.1 Criteria selection and construction of the classification function

Do the criteria selected satisfy the requirements of logistic regression?

All soft factors should be integrated into the model in standardized form as independent variables, and should at least approximate metric scaling.

Is information provided on the form of the logistic regression function?

Estimated *a priori* probability is expressed as a logistic sigmoid curve.

2.2 Estimation of logistic regression coefficients

Does the estimation of the model parameters satisfy the requirements of logistic regression?

The estimation of model parameters should be based on the training sample.

The estimated classification function of the logistic regression should be consistent from an economic standpoint. For more information on consistency, see Item 1.3

3 Criteria for neural networks

3.1 Criteria selection, number of layers and neurons

Do the criteria cover all relevant information categories?

Do the criteria satisfy the scaling requirements for neural networks?

In the context of neural networks, direct input of qualitative criteria is technically unproblematic. For direct processing, each qualitative criteria characteristic requires an input neuron. For instance, the qualitative criterion “accounting behavior” may have the following characteristics: “conservative”, “neutral” or “progressive”; these three input neurons are thus integrated into the network. For even more detailed characteristics, additional corresponding input neurons are required. Qualitative criteria quickly lead to more complex networks and very involved computation procedures.

Does the model use Back-propagated Delta Rule Networks (multilayer preceptrons) or Radial Basis Function Networks?

How many layers are included in the neural network and how many neurons does each layer comprise?

What activation functions are employed? Which sigmoid functions are applied, or does the model use Gaussian distribution?

3.2 Training of the neural network

Which computational algorithm (supervised or unsupervised) is used?

Which pruning methods were applied and how many training runs are conducted?

Are sensitivity analyses used to monitor the impact of the input parameters?

Is the training sample sufficiently large to provide a useful indication as to the classifications of the sample to be analyzed?

Does it represent a good cross-sample of current and future obligors?

3.3 Performance measurement of the neural network

Has the overall sample been separated randomly into the three discrete sets: training, holdout and validation?

The data from the training sample serves to calibrate the model parameters. The holdout samples are applied for the selection of the best model alternatives, the results of which are used as a benchmark for the performance of the neural network. Validation (backtesting) is accomplished with the help of the third, independent validation sample, which should only contain “as yet unaffected” companies.

4 Criteria for data clustering models (e.g. support vector machines)

4.1 Data basis (sample requirements)

Does the data basis satisfy the requirements of cluster models?

Unmodified, this model is only suitable for use with metrically scaled input data. Nominally and ordinally scaled data must be mapped to a cardinal scale.

For support vector machines (SVM):

The model implements a Bayesian estimator for classification. This allows optimal *a priori* classification of imprecise input vectors.

Missing data must be accordingly represented in the input vectors. Care must be taken to ensure that the missing data is taken into account as such by the model.

4.2 Estimation of an approximation or classification function

Does the estimation of the model parameters satisfy the requirements of the clustering model?

If the data comprises numerous, variously scaled values, common, multi-dimensional scaling of the input data can be useful.

For support vector machines:

An SVM is basically a mathematical-statistical model. Certain free modeling parameters, however, such as the form of the risk function or modifications for missing variables, must be determined by an expert.

The modeling estimate results in the support vectors and the Lagrange Multipliers, which represent class prototypes in the classification process. A review should be conducted with respect to the economic relevance of the input criteria for these prototypes.

5 Criteria for decision tree models (e.g. CART)

5.1 Construction of the classification function

Is information provided on the construction of the classification function in the decision tree model?

The definition of the potential (rating) classifications of the subjects (obligors) under consideration must be provided, and the selection of potential discriminant variables explained.

The impurity function that determines the characteristics of the discriminant criteria must also be defined, and the selection of the criterion explained.

The application of substitution splits in the case of missing values for the subjects to be classified, i.e. the use of other criteria values with similar classification effects, is permitted, but must be sufficiently documented.

5.2 Estimation of the default classification rate and determination of end nodes

Is information provided on estimation of the default classification rate for the model?

The resubstitution estimator or other estimator of the default classification rate used to determine the optimal size of the decision tree, i.e. the ideal number of steps needed to reach a final grouping of the set under consideration (end nodes of the decision tree) should be defined. The selection of this estimator should also be explained.

Is information provided on determination of the end nodes?

The method used to assign the end nodes of a decision tree to their specific classifications must be described. The selected assignment must result in an optimal default classification rate of the training set.

The method for final determination of tree size based on the default classification rate should be presented and the default classification rate of the final decision tree tested and documented using a holdout sample. The method used for testing with the holdout sample should be explained, with particular elaboration on how the original training sample was separated into a new training sample and accompanying holdout sample.

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