Comments by

the Association of German Public Sector Banks[1]
and
the Association of German Pfandbrief Banks[2]

ESMA call for evidence
on the assessment of compliance of credit rating agencies with Article 8.3 of the Credit Rating Agencies Regulation (1060/2009/EC)

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[1] The Association of German Public Sector Banks – Bundesverband Öffentlicher Banken Deutschlands, VÖB – is a leading industry association in the German banking industry. It represents 62 member institutions including the regional banks (Landesbanken) as well as the development banks owned by the federal and state governments.
[2] The Association of German Pfandbrief Banks (vdp), headquartered in Berlin, currently represents 39 member banks. The association represents the Pfandbrief-specific interests of its member institutions in dealings with legislators, supervisory authorities, rating agencies and other market participants. It places its specialized services at the disposal of all Pfandbrief-issuing banks in Germany.

7. What do you consider to be the most important factors within a credit rating methodology to ensure that it is:

a. **rigorous;**
b. **systematic;**
c. **continuous; and**
d. **subject to validation based on historical experience, including back-testing?**

Please provide as much detail as possible, including reasons, and please list each factor by reference to each requirement.

Credit ratings and their credibility depend on the validity of the underlying methodologies and models. Users of credit ratings as well as issuers have to be able to understand how a certain rating is derived. Transparency is therefore the utmost important requirement for credit rating methodologies.

Rigorous

Rating agencies should be required to outline and explain the underlying parameters and their effects within the model transparently and comprehensibly. This will allow issuers and users of credit ratings to fully understand the composition of a rating and evaluate its actual significance. Therefore, credit rating agencies should consult changes to their methodologies and models with market participants before introducing them.

Furthermore, data requests should only take place once the methodologies have been developed and published. Additionally, the requested data should only be limited to what is necessary for the model. A general data collection by credit rating agencies – independent from models and methodologies – must be avoided.

In addition, only those agency employees that possess adequate education, expertise and experience should be able to develop and apply rating models. Developing an adequate credit rating methodology necessitates a deep understanding of the respective sector both globally and nationally, strong knowledge of the regulatory environment, and excellent mathematical and theoretical skills. However, analysts should have the room and flexibility to take qualitative data such as bank-specific features into account.

Credit rating agencies should also be required to follow a certain time frame. Especially in the event of a change to methodologies or models, credit rating agencies should be obliged to publish information at a specific time, determined by the regulator. This will make the process for all market participants more predictable and reliable.

Lastly, we suggest creating an arbitration board that will help solve differences between market participants and credit rating agencies over the content and concept of proposed and applied methodologies. So far, past public consultations by credit rating agencies have not been effective to solve those differences.

Systematic

The development and application of credit rating methodologies should take place via a transparent and clearly structured process that involves a public consultation and a response to criticism by market participants. All received statements should be made public.

In addition, the same assumptions, methodologies and conclusions should be applied consistently to issuers or financial products that are comparable. The credibility of credit ratings depends on their comparability across sectors and asset classes. Therefore, a special treatment of, for example, sovereign ratings should be avoided.

Continuous

Continuity should not only be a requirement for ratings and their methodologies, but also for analysts and agency employees in general. Whereas ratings and their methodologies should be reviewed frequently and, if necessary, adjusted, agency employees should similarly undergo a frequent assessment to ensure the highest quality of the overall rating process.

In addition, changes to methodologies that lead to changes in credit ratings should be communicated clearly and timely. However, the basic structure of the underlying credit rating model should remain unchanged for an extended period to guarantee the credit ratings' stability and credibility.

Validation

We expect rating methodologies and models to be regularly validated. This will ensure the ratings' validity and reliability. Back-testing results and the underlying models should be documented and published.

8. In relation to each of the factors identified in Q7, is there a factor that is not covered in the standards embodied in the CESR Guidance published on 30 August 2010? If so, please provide reasons as to why that factor should be included in the RTS.

In addition to the above mention requirements, credit rating agencies should be obliged to consult rated companies before new or revised rating models are put in place. This will provide issuers with the opportunity to validate assumptions and conclusions before they are affected by them.

Credit rating agencies should also be able to incorporate ratings of other agencies and internal ratings that have been approved by the national regulator in their rating methodologies.

9. Are there any factors covered in the standards embodied in the CESR Guidance that you do not consider to be important? Please identify factors and provide reasons.

None.

10. Do you consider that the requirements of Article 8(3) could be met without implementing any of the standards embodied in the CESR Guidance? If so, do you consider this would result in a greater or lower efficiency for CRAs and/or stakeholders? Please provide details. If there are less burdensome alternatives that would secure equivalent effects, please describe them.

To meet the requirements of Article 8(3), we deem implementing all CESR guidelines necessary. It will enhance ESMA's ability to assess the compliance of the credit rating agencies' process of developing, applying and evaluating credit rating methodologies and models with the standards put forward in Article 8(3).

11. What factors, if any, might be relevant to ESMA in determining whether the frequency of assessment should be more or less frequent? For example, the CEBS "Revised Guidelines on the recognition of External Credit Assessment Institutions" published on 30 November 2010 suggests the level of assessment could be reduced for a rating methodology which is supported by quantifiable evidence of producing robust credit ratings.

We find the frequency of one year to be adequate. More frequent assessments are not necessary and would not necessarily result in greater rating quality. However, issuers and the regulator should be able to demand a credit assessment should the rating agency omit reassessing the previous credit rating.

Moreover, the evaluation delivered data, meetings with management and the actual rating decision by the rating committee should take place in a timely manner to ensure that all information leading up to the rating decision are up to date.

12. Do you expect any of the standards embodied in the CESR Guidance, if transposed to RTS, to have any impact on existing or future credit ratings? If so, please specify which type(s) of rating (e.g. corporate, structured finance, financial institution, insurance, sovereign ratings) and what the impact(s) will be. Please specify how the impact will occur and allocate the impact to each standard embodied within the CESR Guidance.

We don't expect any rating changes as a consequence of the implementation of the CESR Guidelines. Though Article 8(3) will increase transparency and quality of the rating process, it will not change the content of the credit rating methodologies and the rating process and, thus, will not impact the actual credit ratings.

However, analysts should remain able to include bank-specific and, therefore, qualitative data into their evaluation. Here, a change in requirements could possibly lead to rating adjustments.

13. Will the standards embodied in the CESR Guidance, if transposed to RTS, have an impact on market size, market structure and your position in the markets within which you operate? Specifically, do you expect:

a. Markets to grow, shrink or to remain unaffected? Please specify and explain.
b. Your competitive position to be enhanced or weakened? If so, please elaborate.
c. The introduction of prohibitive barriers to entry to new CRAs? If so, please elaborate.
d. Disproportionate impacts (e.g. market exit) on smaller or local CRAs? If so, please elaborate.

We do not expect any changes to the business environment and competitiveness of banks due to the implementation of Article 8(3). The banking market should remain unaffected.

14. What costs or benefits do you expect the standards embodied in the CESR Guidance, if transposed to RTS, to have on financial markets or the wider economy, for example, through:

a. Changes to regulatory capital holdings?
b. Effects on the price of raising capital?
c. Improvements in mitigating risks to the financial system?
d. Using credit ratings of better quality?

The benefits of implementing the CESR Guidelines include a more transparent rating process and a higher quality of the credit rating itself. This will enhance the credibility and validity of the ratings among investors and should increase competition among credit rating agencies.

Implementing the requirements of the regulation of credit rating agencies consistently across EU-members would also protect all issuers against credit rating agencies' violation of the regulation's requirements.

However, the costs will be partly borne by issuers. Due to the high administrative costs for the credit rating agencies, we expect rising fees.

15. Do you expect any other cost(s), benefit(s) and/or impact(s) that are not covered in these questions? If so, please specify.

None.

Appendix

(i) Name of organizations

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(ii) Annual revenue

n/a

(iii) Nature of business

Association

(iv) Areas of specialization

Financial institutions, structured finance