vdp

VERBAND DEUTSCHER PFANDBRIEFBANKEN

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Response to CESR's

Questionnaire regarding the rating of Structured Finance Instruments

The Association of German Pfandbrief Banks (vdp) welcomes the opportunity to comment on the questionnaire regarding the rating of Structured Finance Instruments.

The vdp members number among the most important providers of capital for residential and commercial properties as well as for the public sector and its institutions. These funds are mainly raised through the issuance of Pfandbriefe, which are Covered Bonds based on a strong legal basis and a strict special public supervision. Therefore there are significant differences between Pfandbriefe and Structured Finance Instruments like Mortgage Backed Securities (MBS). However, rating agencies often use similar or even the same models in quantifying credit risk and other related risks. Beside Pfandbriefe both true sale and synthetic MBS are used heavily by our members. Hence, they have to deal with rating agencies many times and in many ways.

The vdp represents roughly 90% of the Pfandbrief market which underlines its position as one of the leading banking associations in Germany. It should be added that with an outstanding volume of EUR 948.8 billion at the end of 2006 the Pfandbrief ranks at a top position within the European bond market. The Pfandbrief is the benchmark in the European Covered Bond segment and holds 50% of the entire market.

B) Questions addressed to the users of ratings and other interested parties

Rating process

Question 1: Do you consider that access to and availability of structured finance ratings (and any subsequent changes) is satisfactory?
In general, Structured Finance issuers face the same problem as those in the plain vanilla market. There are only the three rating agencies Fitch, Moody's and Standard&Poor's whose ratings are widely accepted by most investors. In practice, many benchmark MBS are rated by all three agencies as this is demanded by huge investors. Hence, the Structured Finance market is confronted with a monopoly on the rating side. The same is true for huge Pfandbrief issuers that try to achieve a high investor diversification. It remains to be seen whether DBRS will be able to place itself as a true alternative to the three existing big rating agencies.

Question 2: Are you satisfied with the CRAs disclosures on their fees policy?
It is not the disclosure on their fees policy that can be criticised. As a result from the mentioned monopoly (or at least oligopoly) it is their power to set fees which is remarkable. While smaller Pfandbrief issuers not necessarily need all three ratings huge Pfandbrief issuers as well as MBS tranches do have to have three ratings which puts them in a weak position in fee negotiations.

Rating methodologies

Question 3: What are your views on the fact that the agencies use different analytical models to assess the portfolio credit risk? Are you satisfied with the way the rating agencies assess such risk?
As mentioned above Pfandbrief and MBS have some similarities and many differences. The Pfandbrief is based on the German Pfandbrief Act and enjoys a strict special public supervision. The legal requirements for eligible assets lead to a very low credit risk within the cover pool, while other rules address the interest- and currency risk as well as the operational risk and – to a lesser extent – the liquidity risk in the cover pool. These strict legal rules do not exist in the Structured Finance World. Rating agencies have

acknowledged these differences by implementing special Covered Bond rating methodologies.

However, rating agencies often use the same models in quantifying credit risk and other related risks within the cover pool of Covered Bonds (including Pfandbriefe) and MBS. By doing so they more or less ignore the legal safety net. The use of derivatives is another aspect where rating agencies do not distinguish properly between highly regulated Pfandbriefe and unregulated MBS. One has to keep in mind that for MBS, rating agencies offer the only quality control, while Pfandbriefe are controlled by an independent cover pool monitor and are supervised by the public authority BaFin.

Question 4: Are you satisfied with the way the rating agencies assess the structural risks of the deals (i.e.legal risks, cash flow analysis, third parties' involvement in the transaction)?
In the rating process of Pfandbriefe and MBS, rating agencies have to perform legal and economic analyse. The difference is that for Pfandbriefe the legal analysis is concentrated on the Pfandbrief Act and has to be done just once. In Structured Finance Instruments, each structure has to be analysed separately. Not having enough staff skilled in legal aspects, rating agencies use legal opinions from law firms. The first thing to criticize is that they seem to trust more in legal opinions than on legal frameworks even in the Covered Bond universe, where legal opinions are used when no Covered Bond law exists or when rating agencies question some legal requirements. Another problem is that these legal opinions are not being made public. Therefore, market participants have no chance to judge those legal opinions.

Question 5: Are you satisfied with the way the CRAs disclose their methodologies?
Rating agencies disclose their Covered Bond rating methodologies in a proper way. After the discussion about a possible regulation of rating agencies started, they have begun to consult market participants before changes in the methodology are implemented. However, these methodologies just form the framework. In some cases the models (e.g. for their cash-flow analysis) are not made public.

On-going surveillance of the transactions

Question 6: Are you satisfied with the frequency and quality of the information provided by the rating agencies to the market in connection with the monitoring of rated structured products (e.g. monitoring reports, special comments, etc.)? Are you satisfied with the frequency and quality of the information provided by the issuers/arrangers of structured transactions in order to monitor rated structured products?
No comments

Questions 7: Are you satisfied with the CRAs disclosures on the reasons for a change in a structured finance rating?
No comments

Potential risks (conflicts, resourcing)

Question 8: Are there any risks unique to rating structured finance compared to corporate credit rating?
Rating agencies play a very important rule in Structured Finance transactions as they offer the only on-going quality control. In addition, the more complex a structure is the fewer investors are able to evaluate the structure on their own. Hence, many investors rely heavily on external ratings (probably some of them exclusively). Therefore, some agencies might be tempted to push market developments in the direction of complex structures.

Question 9: Are you aware of any CRAs which provide ex post ancillary/advisory services? If so, do you perceive any potential conflicts of interest between the structured rating activity and any ex post ancillary/advisory services those CRAs may provide (i.e. pricing or valuation models)?

No comments

Question 10: Is there a risk of conflicts of interest when a rating agency provides the rating of the provider of credit enhancement to structured finance products it has also rated?
No comments

Question 11: Are you satisfied with the way the agencies' communicate the measures they have adopted to manage those potential conflicts of interests?
No comments

Question 12. Do you think those measures are effective?
No comments

Question 13. Is there sufficient resource and experience at the rating agencies to deal effectively with the demand for structured finance ratings?
No comments

IOSCO Code on Structured Finance

Question 14. Does the current IOSCO Code of Conduct for CRAs deal appropriately with the risks in the rating of structured finance?
No comments

Additional comments

Question 15. Are there any additional points you would like to raise, on the basis of your experience in the structured finance business?
No