



**aba response**

**to the Discussion Paper**

**The Use of Credit Ratings by Financial Intermediaries**

**Article 5(a) of the CRA Regulation**

**Response by:**

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**About the aba:**

The aba - Arbeitsgemeinschaft für betriebliche Altersversorgung e.V. - is the German association representing all matters concerning occupational pensions in the private and public sector. The aba has 1,200 members including corporate sponsors of pension schemes, IORPs, actuaries and consulting firms, employer associations and unions, as well as insurance companies, banks and investment managers. According to our statutes, our mission is to represent existing schemes as well as to expand coverage of occupational pensions independent of vehicle.

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## Responses to the questions

### ***Q9. To what extent do your business lines use external ratings? Please specify by activity.***

IORPs generally use external ratings for their credit risk assessment of issuers; ratings are therefore important for the asset allocation of IORPs. However, for this question it is important to distinguish between direct and indirect investments. Direct investments cover securities bought by the IORP directly based on its own in-house investment process. Indirect investments cover securities bought through an external fund manager, whereby the investment process is outsourced to the manager.

For **indirect investments**, which are managed by specialised asset managers, we see the investment management company (in Germany: KVG) or the asset managers as solely responsible for the observation and the use of credit ratings in line with the respective investment guidelines. This position is also held by BaFin as German competent supervisory authority in its advice (see Bundesanstalt für Finanzdienstleistungsaufsicht, Requirements for Insurance Companies and IORPs)<sup>1</sup>. It should be ensured through the respective investment committee or the rules laid down in the specific fund conditions that the investment management company complies with the supervisory and individually set requirements regarding credit ratings and assessment of creditworthiness. It is standard practice for IORPs to require written confirmation of compliance with legal requirements. In discussing individual investments the IORP might instruct the investment manager to deviate from the proposed allocations, to refrain from buying securities from certain issuers (even though their credit rating might be acceptable) or to tolerate passive guideline-breaches by continuing to hold recently downgraded investments. Summing up, overruling is possible and IORPs are currently doing it.

Moreover, it is understood that in actively managed investment mandates, the manager has a credit research process in place which ensures that investment decisions are not purely based on external ratings.

Regarding **direct investments**, from our perspective the respective requirements of BaFin (see again the BaFin requirements)<sup>2</sup> are adequate and could be considered good practice across the EU, in particular the required plausibility checks (Plausibilisierung). IORPs would welcome if rating agencies were required to provide their rating reports free of additional charge to them, so that they could be used as a basis for the plausibility checks.

While there are important differences between direct and indirect investments, we would like to stress that investment decisions of IORPs in both instances are never based exclusively on credit ratings. Nevertheless the use of an external rating should be possible at least in cases where other external ratings are available for plausibility checks.

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<sup>1</sup> [BaFin Notes on the use of external ratings and on making own credit risk assessments](#)

<sup>2</sup> [BaFin Notes on the use of external ratings and on making own credit risk assessments](#)

**Q9 i) What are the main reasons to use external ratings in contractual agreements?**

From our perspective, there are a number of reasons:

- **Simplicity:** The most important reason is of course to define a simple, practicable and objective criterion for investment guidelines for external managers regarding which investment qualities are generally acceptable.
- **Relative low cost:** Because of the specialisation of credit rating agencies, economies of scale lead to lower costs for the provision of credit assessments (compared to the costs of IORPs producing ratings internally).
- **Information advantage:** Credit rating agencies have confidential insights into company documents and discussions with management, which IORPs do not have access to.
- **Expertise and experience:** Credit rating agencies have had many years of working in the area, building up expertise learning from experience.
- **Standardised processes:** Credit rating agencies follow well-established and clear processes based on sound methodologies when assessing credit worthiness.

The last three points should, ceteris paribus, lead to a superior credit assessment by ratings agencies.

While IORPs could in theory run the same standardised processes as credit rating agencies, they are likely to produce results in lower quality and at higher costs because of their lack of experience, expertise and limited capacities.

**Q9 ii) Are there elements in your contractual agreements that limit or mitigate the risk of sole and mechanistic reliance on external ratings?**

Usually there are references to several different ratings from different agencies in the contracts between the IORP and the external manager. These criteria can be overruled by individual IORP decisions. There are no automatisms in place which cannot be altered by discussions with the investment manager (see also answer to Q9). Another risk mitigating factor is the consideration of expert assessments for example regarding investments in emerging markets.

We welcome the “European rating platform” starting on 1<sup>st</sup> January 2017.

**Q10. What in your view are the main advantages or disadvantages of using external ratings?**

Advantages:

- **Simplicity:** Easy to use for institutions whose core business does not focus on credit rating.
- **High degree of objectivity:** Objective criterion about which credit qualities are generally acceptable and which are easy to describe / implement in guidelines and contracts.
- **Relative low cost:** Because of the specialisation of credit rating agencies, economies of scale lead to lower costs for the provision of credit ratings (compared to the costs if IORPs produced ratings internally).

- **Information advantage:** Credit rating agencies have confidential insights into company documents and discussions with management, which IORPs do not have access to. This is particularly important for forward looking analyses.
- **Expertise and experience:** Credit rating agencies have had many years of working in the area, building up expertise learning from experience.
- **Standardised processes:** Credit rating agencies follow well-established and clear cut processes based on sound methodologies when assessing credit worthiness.

Disadvantages:

- **Small number of providers:** There is still a reliance on a small number of providers, but the number of providers has increased in the aftermath of the financial crisis.
- **Lack of specific information:** It is difficult to get specific information for individual investments.
- **Certain degree of subjectivity concerning forward looking analysis:** Ratings rely partially on subjective impressions of individual analysts who are using forward looking figures which are partially produced by the respective issuer. However, the analysis of accounting figures used by rating agencies is based on classical and generally accepted measures of credit analysis. Any own assessment of the IORP would use quite similar measures and any forward looking analysis is an approximation.

***Q11. Do you conduct any analysis of the underlying methodologies of the ratings you rely on? If so what in your view are the strengths and weaknesses of the methodology?***

It is important here to distinguish between the analysis of data to determine the current creditworthiness and forward looking projections. As explained in the answers to Q9 i) and Q10, the analysis of data to determine current creditworthiness follows standard processes and is not specific to credit rating agencies. It is relatively straightforward and there is no real reason to question the methodology.

The forward looking projections are much more subjective. However, because of the information advantage of the rating agencies it is harder here to question the methodology. If the IORP wants to use forward looking analysis, it still seems a sensible approach to use rating agencies and their information advantage.

If in some cases the IORP has current and reliable information, the IORP should of course make use of this knowledge in addition to the official credit rating. Generally it is beneficial if within the IORP there are clear processes in place which amongst other issues deal with this eventuality.

***Q12. Can you provide examples of past experience where external credit ratings provided an inaccurate credit worthiness assessment? If so, what actions were taken in response to mitigate similar occurrences?***

Probably the most well-known recent example of credit rating failure is the Lehman bankruptcy. However, we would like to stress that we are not aware of a credit rating mechanism which would have foreseen the Lehman bankruptcy.

Taking a broader view we believe that credit rating agencies caused problems in the area of structured products such as collateralised debt obligations (CDO) and collateralised loan obligations (CLO). Credit rating agencies were involved in both the design and credit assessment of these products. Since they had a financial stake

in these products, they were exposed to moral hazard. Doubts regarding the quality of these products together with the growing scarcity of liquidity led to a collapse of the respective markets. From our perspective in addition to the retention requirement for originators CRA III introduced several measures with regard to originators of securitized products and to rating agencies to separate product creation and product rating even more and to avoid conflict of interest. It is now important that the credit rating agencies comply with these rules and do not get involved in product creation.

In addition to separating product creation and credit rating, several other regulatory measures have been taken to mitigate the risk of future failure of credit ratings. Most important from our perspective was the introduction of an issuance calendar for sovereign debt (at the end of the calendar year stating the planned ratings for the following year) and the supervision of rating agencies (i.e. additional reporting requirements and the introduction of a legal liability of rating agencies or the new rules regarding investments in rating agencies) in the context of CRA III

***Q13. What internal risk analyses do you currently employ? What business lines are these employed in? To what extent do they utilise external ratings? What are the main advantages of these internal analyses?***

Since the analysis of accounting figures used by rating agencies is based on traditional and generally accepted measures of credit analysis, potential own assessments would use quite similar measures. Conducting internal analyses based on identical methodologies and processes creates additional cost without adding value or fresh insights.

From our perspective it is therefore important that no new rules are introduced for IORPs requiring them to conduct their own internal credit ratings. While some larger IORPs might do internal assessments for important investments and there is always the option of conducting additional internal analyses (e.g. taking into account given guarantees or securities), this should not become a general requirement for IORPs. Overall, the requirement to conduct plausibility checks (Plausibilisierung) for direct investments should be sufficient. IORPs would welcome if rating agencies were required to provide their rating reports free of additional charge to them, so that they could be used as a basis for the plausibility checks.

***Q14. Please specify what alternative references or benchmarks your internal risk analyses make use of.***

Overall, IORPs tend to use publicly available data or analyses for their internal risk analyses, they rarely use raw data to do the calculations themselves. To give an overview:

1) Analysis of publicly available press clippings and research publications

- Trade press (e.g. Börsenzeitung in Germany); website of the issuer (e.g. for annual financial statement, risk management reports)
- Research departments in banks provide extensive analyses, which could be used for internal credit assessments; e.g. on special websites for institutional investors (for example assessments covering individual issuers, the Covered Bond Newsletters, development of cover funds of German Pfandbriefe, Staatencompass, Credit-Newsletter).

2) Analysis of the key contractual data

- 3) Use of additional market data such as CDS or credit spreads where available.
- 4) Assessment of creditworthiness by asset managers and investment management companies
  - Asset managers and investment management companies often have their own credit processes. In this case it could be possible that the already existing information is used as an additional creditworthiness assessment within the internal credit process.
- 5) Plausibility check of one external rating by comparison with another external rating where available

***Q15. Are these alternative measures point-in-time or through-the-cycle compared with external ratings?***

Both methodologies are used depending on the specific case or question.

***Q16. In what areas is reducing reliance on external ratings necessary or at least desirable?***

We currently see no excessive reliance on external credit ratings. Therefore there is no need for new legislation in this area to reduce the reliance on external ratings (see our responses to Q9 to Q15). From our perspective, the BaFin Notes on the use of external ratings and on making own credit risk assessments (see footnote 1) are sufficient.

***Q17. What in your view are the main challenges preventing you from reducing reliance on external ratings in your business?***

Developing their own credit analysis processes (potentially comparable to those used by credit rating agencies) would overburden many investors, particularly IORPs. They usually only have limited business operations and in addition would not bring significant new insights because in most cases similar methods are likely to produce similar results. Credit rating agencies work with traditional credit quality key figures – they observe their developments and then extrapolate them into the future.

This would not be the same when conducting an internal credit assessment. Discussions with managers or other key professionals of the issuer, as often conducted additionally by credit rating agencies, cannot be carried out by IORPs. In addition, IORPs often have limited business operations. The type, scope and complexity of the work IORPs conduct has to be considered accordingly. Importantly, there would be no information gain if the processes already conducted by rating agencies would be duplicated by IORPs.

***Q18. How could the reduction of contractual references to credit ratings influence, in your opinion, the transmission of systemic risk?***

Such a reduction carries the danger that other additional risks arise, e.g. less minimum requirements in contracts and guidelines regarding credit quality. So it should also in the future be possible to use references to external ratings in such contexts. This can in general not take away the responsibility of the IORP to develop in many cases an own credit opinion.

As stated several times above, credit rating agencies are much better placed than IORPs to develop credit ratings which should be considered when seeking to reduce the transmission of systemic risk. This means that

only in the rare cases where IORPs hold special knowledge, internal analyses could provide additional value. However, it should be possible to deviate from the external credit rating if the IORP sees advantages in doing so. This possibility exists today and is used by IORPs.

***Q19. Are there any additional points you would like to highlight with regards to contractual reliance on external ratings?***

The aba welcomes the approach of more stringent regulation of credit rating agencies generally and in particular welcomes respective measures with regards to the negative effects during the financial crisis. In this context it is also necessary to reduce the reliance of investors on credit rating agencies caused by supervisory requirements alone. Supervisory requirements for investors (such as IORPs) to only rely on issue rated by established credit rating agencies in as far as possible, and including specific requirements, which rating categories are considered “safe”, lead to a strong dependence in the current regulatory environment. In periods when financial markets are under stress, this dependence can lead to “fire sales”, which are set off by the regulatory environment. Negative market developments can be compounded by these processes.

Since the beginning of the financial and sovereign debt crisis – the context in which also credit rating agencies and their role in the crisis has been criticised by many – we have been witnessing developments which call for a new analysis of the situation. On the one hand more than the big three credit rating agencies (S&P, Moody’s, FITCH) have established themselves in the market over the past years, on the other hand investors are dealing much more consciously with the credit risk in their assets.

From our perspective, the implementation of internal credit ratings by investors (such as IORPs) called for in the context of the EU Regulation on Credit Rating Agencies is off target. Usually investors will not rely exclusively on any individual rating of a single credit rating agency. Even the use of several ratings from different and independent credit rating agencies which was made possible because of the increased number of credit rating agencies is already a significant development of creditworthiness assessments compared to the situation before the financial crisis. In addition, credit rating agencies have significantly developed their practices over the last years and have published their processes and systems for assessing creditworthiness. This enables investors to understand how the credit ratings are derived, and both to appreciate and criticise them.

When regulating credit rating agencies, the European Supervisory Authorities should closely consider who uses these ratings, and for which purposes. New requirements for IORPs should be designed in a way so that they are not too taxing for them. Where necessary, the European Supervisory Authorities should offer support for investors using these ratings, in particular smaller ones. This would both strengthen IORPs – and, importantly, the occupational pensions of many Europeans – as well as the overall stability of the European economy.

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