



European Securities and
Markets Authority

Call for Evidence Investor Response

Competition, choice and conflicts of interest in the credit rating industry



Responding to this call for evidence

This call for evidence should be read by all those involved in the credit rating industry. It is particularly targeted at the following market participants and the groups and trade associations who represent them:

1. Corporate and sovereign issuers of financial instruments requesting credit ratings.
2. Credit rating agencies issuing credit ratings.
3. Institutional investors and other users of credit ratings.

There are specific questions for corporate and sovereign issuers in section 4 of the call for evidence, followed by questions for credit rating agencies in section 5 and for investors in section 6. ESMA invites respondents to provide information about each relevant set of questions using the template response forms provided for each group.

Responses are most helpful to ESMA where they clearly indicate which question is being answered and provide evidence in support of the response, such as concrete examples of practices experienced, data or costs estimates.

ESMA will consider all responses received by **31 March 2015**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the call for evidence, unless you request otherwise. Please clearly and prominently indicate in your submission any part that you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

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Acronyms used

CEREP	ESMA Central Repository for publishing credit rating activity and performance statistics
Commission	The European Commission
CRA	Credit rating agency
CRA Regulation	Regulation 1060/2009 on credit rating agencies as amended
ESMA	European Securities and Markets Authority
EU	European Union

Executive Summary

Reasons for publication

ESMA is publishing a call for evidence to collect information from market participants about the functioning of the credit rating industry and the evolution of the markets for structured finance instruments as required by Regulation 1060/2009 on credit rating agencies as amended (the CRA Regulation). ESMA is seeking evidence about competition, choice and conflicts of interests in the credit rating agency industry in general as well as about the impact of a number of specific provisions of the CRA Regulation.

Contents

This template response form contains the questions to be answered by investors and other users of credit ratings found in Section 6 of the call for evidence.

Respondents may need to disclose commercially sensitive information to ESMA in order to answer some of the questions asked. ESMA intends to present confidential information in anonymised and aggregated form in its Technical Advice so that individual respondents cannot be identified. In order to facilitate this process, ESMA therefore asks respondents to clearly indicate which parts of the answers to each question they believe to contain confidential information.

Next Steps

ESMA will carefully consider all responses to the Call for Evidence received by the deadline of 31 March 2015. The evidence obtained will be analysed by ESMA as part of the development of the Technical Advice to be provided to the European Commission pursuant to Articles 39(4) and 39(5) of the CRA Regulation.

6 Questions for investors and other users of credit ratings

6.1 About your organisation

1. The questions in this part aim to obtain information about the nature of the organisation you represent and the different markets in which you are active. This information will help ESMA to put your responses in context and to compare responses from similar respondents.

Q1: Please provide the name of your organisation.

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Q2: Please explain whether you invest in instruments with credit ratings at local, national, EU and/or global level. If your organisation invests in instruments at EU or global level, please provide a list of the jurisdictions covered.

At all levels

Q3: Please explain whether you invest in CRAs or related companies, and if so, provide a list of these and your percentage shareholding in each.

No specific policy

6.2 Due diligence and use of credit ratings

2. The CRA Regulation aims to increase investor protection and reduce reliance on credit ratings through a number of transparency and disclosure requirements.
3. The questions in this part aim to understand what impact the CRA Regulation has had on how you use credit ratings in the course of your business and whether there is other information which you could use to assess credit risk instead of credit ratings.

Q4: Please explain the due diligence process you follow and the types of information you consider in order to decide which instruments to invest in.

Investment process requires several steps to be taken from the investment idea to the investment decision and its realisation. Each individual issuer's creditworthiness is assessed by internal credit analysts that undertake personal analysis of balance sheet and activity data. Each individual issue is further analysed from its legal and financial point of view. Qualitative and

quantitative data are processed and CRAs opinions are usually considered among those different data.

Q5: Please explain whether your overall use of credit ratings in the course of your business or in making investment decisions has increased or decreased since 2010, giving reasons for your answer.

Tendency to reinforce our internal credit analysis capacity over the last 5 years.

Q6: Please explain whether and if so what information you use to assess the quality of credit ratings.

It is not part of our job to assess the quality of credit ratings. We make independent credit analysis of issuers and issues before investing. We may have a more positive or more prudent view than a CRA but that does not imply that we contest the quality of the rating issued by a CRA.

Q7: Please explain whether and if so to what extent you use internal rating models in addition to or instead of credit ratings in your business or investment decisions.

We have seasoned professional credit analysts to support our investment decisions. Their opinion is expressed more as an authorization to invest up to a given limit than as a level of rating. If they may use a quantitative approach we do not consider that the wording "rating model" properly reflects the process they follow.

Q8: Do issuers or CRAs currently give you more information about how their credit ratings are developed, issued and revised and how their credit ratings compare to the market performance of the rated instruments than they did before 2010? If so, does this additional information make it easier for you to understand and compare:

(1) the ratings products and other services being offered by different CRAs;
and

CRAs actively promote their products, as they did before 2010.

(2) the quality of the credit risk analysis carried out on rated instruments?

Transparency on rating processes has globally improved over the last five years. To illustrate : when CRAs introduce changes or new developments in their methodology they tend to consult market participants ahead of time much more than they used to.

Q9: Are there other sources of information which you would use to make investment decisions instead of credit ratings?

We use many other sources such as report and accounts of the issuer, prospectus of the issue, press releases, external and internal research... and consider CRAs ratings as one source of information among many others. Ratings published by CRAs are not decisive in the investment process, except for those portfolio where rating limits are explicit.

Q10: Please explain whether and if so how your business uses unsolicited credit ratings, giving reasons for your answer.

We do not consider unsolicited ratings as being of the same quality as ratings published with the authorisation of the issuer.

Q11: Please explain whether, and if so how, your approaches to the issues raised in questions 4-10 above have changed since 2010.

There is a clear-cut difference between the historical activity of bond rating and the other developments such as structured finance or funds ratings. We do not consider that the traditional bond rating activity failed at the end of the first decade of the 21st century. Conversely, we were very cautious on CRAs activities in structured finance and still are.

6.3 Independence and quality of credit ratings

- 4. One of the aims of the CRA Regulation is to increase the quality of credit ratings by seeking to reduce the conflicts of interest inherent where issuers pay for the rating of their financial instruments.¹**
- 5. The questions in this part aim to understand the different ways that CRAs can seek payment for the credit ratings issued and to assess the impact of the CRA Regulation on increasing the quality and independence of credit ratings.**

¹ See Recital 10 of Regulation 462/2013 of 21 May 2013.

Q12: Please explain in which circumstances you currently pay for credit ratings. If you do not currently pay for credit ratings, please explain whether, and if so under which circumstances, you would be willing to pay for credit ratings.

We are subscribers to largest CRAs and receive their ratings. Through our subscriptions, we also gain access to extensive and original data bases that will help in our own credit assessment. We must confess that the exact terms and conditions of these subscriptions are not always satisfactory as to the definition of what is subject to property rights (as opposed to public information), the level of responsibility of the CRAs and the extent of the licence. With the coming into force of Solvency 2, asset managers are required to report to insurance clients the ratings of their holdings and that has raised difficulties that, to our knowledge, only one CRA has accepted to discuss openly. Others just consider that it implies that we subscribe a new licence to become information distributor. This is a key concern today.

Q13: Irrespective of whether you pay for credit ratings, please explain the circumstances in which links or existing relationships between an issuer of a particular instrument and a CRA would have an impact on how you would use a credit rating of that instrument.

We would actually disregard any rating published by a subsidiary or a linked company of an issuer. Otherwise, we do not consider that long standing relationship should be regarded as creating a potential conflict of interests between a CRA and an issuer.

Q14: Please explain whether the quality of credit ratings has increased or decreased since 2010, giving reasons for your answer.

We feel that the rating of corporate senior bonds is the core business of CRAs and consider that CRAs have always made a good job in that field. The extension to subordinated or sovereign bonds seems logical to us. As for the rating of other products such as structured deals or funds, we feel that CRAs produce opinions that have never reached the quality of bond ratings and usually do not use them. The case of funds ratings is a real concern as it implies that the asset manager invest in rated instruments in a mechanistic way and, hence, it creates correlation between ratings that can be highly damageable in case of an error.

Q15: Please explain what, if any, further measures could be taken to increase the quality of ratings, giving reasons for your answer.

CRA should stick to where they have shown proved expertise, i.e. bond ratings. Their developments in other areas should refer to a totally different scoring so that there would not be any risk of confusion. For example the letter scale should be limited to bonds and other instruments should be rated on a numeric scale.

6.4 Multiple credit ratings

6. The 2013 amendments to the CRA Regulation introduced a number of requirements on issuers and sponsors of structured finance instruments to obtain multiple credit ratings. These requirements are set out in Articles 8c and 8d of the CRA Regulation.
7. Article 8c of the CRA Regulation requires issuers to obtain at least two credit ratings for structured finance instruments. This obligation was introduced with the aims of restoring market confidence in complex financial instruments and reducing reliance on single credit ratings.²
8. Article 8d of the CRA Regulation aims to increase competition between CRAs by encouraging issuers to use smaller CRAs when they use multiple CRAs. Article 8d states that where issuers or related third parties intend to appoint at least two CRAs to rate an issuance or entity, they shall consider appointing at least one CRA with no more than 10% of the total market share where possible (hereinafter 'small CRA').
9. The question in this part aim to understand whether these provisions have achieved their objectives and the impact they have had on your business.

Q16: Please explain what impact multiple credit ratings of the same instrument have on your investment or business decisions.

The suggestion to consider multiple ratings is not relevant. The real point is to ensure that investment decisions are not made with an excessive reliance to ratings. It is far better not to consult any rating and proceed with a thorough internal credit assessment than refer to several external ratings with no personal judgement. As an asset manger, we do conduct our own assessment of instruments we intend to invest in and take ratings as one among other information sources.

² See Recital 28 of Regulation 462/2013 of 21 May 2013.

Q17: Please explain whether in your view, issuers should be obliged to obtain multiple credit ratings in respect of some or all asset classes and if so, how many ratings per asset class should be required.

No. If regulators want to incentivize investors to conduct their own credit assessment, they should not suggest that ratings can be sufficient to do it, even if they are multiple.

Q18: Please explain whether you would use ratings from a small CRA, giving reasons for your answer. Please explain whether, and if so how, your approach to this issue has changed since 2010.

We do not favour positive discrimination amongst CRAs. Credibility of a CRA is key when using or referring to a rating. This is not a matter of size but of process and means made available. Larger CRAs tend to have more.

Q19: Please explain whether you would use ratings from a CRA who has not previously rated a particular asset class, giving reasons for your answer. Please also explain whether, and if so how, your approach to this issue has changed since 2010.

In the absence of previous track record of a CRA in an asset class, we refer to its process and organisation to establish whether or not it is possible to work with it.

6.5 Disclosure requirements for structured finance instruments

10. The 2013 amendments to the CRA Regulation sought to increase transparency through the introduction in Article 8b of a joint obligation on issuers, originators and sponsors to publish information on the credit quality and performance of the underlying assets of structured finance instruments.

11. The expression '*structured finance instrument*' is defined as a financial instrument or other assets resulting from a securitisation transaction or schemes '*whereby the credit risk associated with an exposure or pool of exposures is tranced, having both of the following characteristics:*

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme’.³

12. Commission Delegated Regulation 2015/3 of 30 September 2014 sets out the disclosure requirements for issuers, originators and sponsors of structured finance instruments.⁴ Although this Delegated Regulation will only apply from 1 January 2017, its aim of improving transparency is clear. In this part ESMA therefore wishes to understand the benefits and costs of extending these disclosure obligations to other asset classes.

Q20: Please explain whether the requirements of the CRA Regulation for issuers, originators and sponsors to make information available through a website, including information regarding the creditworthiness and performance of structured finance instruments, are sufficient or should be extended to other asset classes, giving reasons for your answer. If so, please explain to which products this obligation should be extended.

The question of transparency on securitisations is not limited to CRAs. It is of paramount importance but relates to the regulation of securitisations and the need for the definition of high quality deals. If CRAs publish on their website information on structured instruments we can only agree and encourage it. However, we do not consider that it should be extended to other asset classes. In our view, it should not reduce the requirements that issuers or originators be more transparent on those instruments.

6.6 Mandatory rotation

13. The 2013 amendments to the CRA Regulation introduced a mandatory rotation provision for CRAs issuing ratings on re-securitisations, which can be found in Article 6b of the CRA Regulation. Article 6b provides that CRAs may enter into ratings agreements for re-securitisations with a maximum length of four years, after which time they are prevented from rating new re-securitisations with underlying assets from the same originator for a period of four years.
14. The CRA Regulation notes that the implementation of a rotation mechanism should remove the incentive for a CRA to give favourable credit ratings to issuers on the basis of their existing relationships and could encourage other CRAs to start rating these instruments.⁵

³ Article 4(1)(61) of Regulation No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation No 648/2012, OJ L 176, 27.6.2013.

⁴ OJ L 57, 6.1.2015, p. 2.

⁵ See Recital 12 of Regulation 462/2013 of 21 May 2013.

15. As the provision was also designed to help stimulate competition, Article 6b2(b) of the CRA Regulation explains that mandatory rotation will cease to apply where at least four CRAs each rate more than 10% of the total number of outstanding re-securitisations.⁶

16. Although this provision has only recently entered into force, the questions in this part are designed to help ESMA understand the impact of this provision and the extent to which it has already been used. They also aim to assess the appropriateness of maintaining a rotation mechanism, whether, and if so how, it should be extended to other asset classes and what impact this would have on issuers and CRAs.

Q21: Please provide details of any experience you have had of this rotation provision to date.

We have no direct experience to share, but a general concern that rotation is not an appropriate answer to deal with potential conflict of interests due to a long standing relationship. In our view it relies on an unjustified prejudice that CRAs are not able to keep an independent view on deals of an issuer or originator when they better know its organisation. We think that competition between CRAs, mainly in terms of credibility, and internal organisation and control within a CRA will best address the issue of potential conflicts of interests.

Q22: Please explain whether a 4-year contract term is appropriate for this rotation provision, and if not, what would be an appropriate length?

We do not support the idea of rotation.

Q23: Please explain whether mandatory rotation should be extended to other asset classes. If so, please:

(1) list the asset classes to be covered and state the appropriate contract length for each;

We do not support the idea of rotation, and oppose its extension.

(2) explain whether, and if so why an obligation should be introduced for CRAs to provide a handover file to the incoming CRA at the end of the maximum contract term.⁷

⁶ See Recital 15 of Regulation 462/2013 of 21 May 2013.

⁷ See Recital 13 of Regulation 462/2013 of 21 May 2013.

No. The aim of rotation is to ensure that there is an independent judgement by a new CRA. Transmission of non public information by the exiting CRA to the incoming one would jeopardize this attempt to have a fresh review.

Q24: Please explain, giving reasons for your answer whether, and if so how, the exemption from the mandatory rotation provision should be maintained where at least four CRAs each rate more than 10% of the total number of outstanding re-securitisations.

We do not support the idea of rotation and totally agree with exemptions, especially when they rely on enhanced competition.

6.7 Competition between credit rating agencies

17. The aim of improving the functioning of the markets within the CRA sector was a major driving force behind the development of the CRA Regulation. The CRA Regulation seeks to achieve this aim by stimulating competition between CRAs, through registration and disclosure requirements as well as through specific provisions regarding the use of multiple credit ratings and the mandatory rotation of CRAs.

18. The questions in this part aim to collect further information about competition between credit rating agencies and whether competition between CRAs has changed since the CRA Regulation entered into force in 2010.

19. ESMA would also like to take your views as to whether, and if so how, competition between CRAs could be stimulated without having a negative impact on the quality of credit ratings.

Q25: Please explain whether you are aware of any competition between CRAs. If so, please explain on which of the following parameters CRAs currently compete:

- (1) quality of rating;**
- (2) relationship with issuers;**
- (3) investor relationships;**
- (4) by asset class;**
- (5) by price to issuer;**
- (6) by level of rating;**
- (7) through the offer of ancillary or non-ratings services; and/or**
- (8) other (please specify).**

Yes, CRAs compete and the first criterion for competition is the visibility of the rating they publish and the level of confidence the market participants put in it. In that respect process and quality of staff and organisation are the most relevant factors. The second criterion will be price paid by the issuer for

services that will seem equivalent in terms of quality. The third criterion is to be found in the quality and proximity of the relationship with the issuer: a more pedagogic approach will be preferred to a non disputable unexplained rating which, finally, is not totally shared with the issuer.

Q26: If you have been aware of competition between CRAs, please explain whether, and if so how, the nature of competition between them has changed between 2010 and present.

We feel that in the field of structured instruments, and more specifically transactions relying on a “blind” portfolio (where the investor does not know the underlyings except that they are validated by a CRA), excesses have been made prior to and during the financial crisis. We believe it is no longer the case but keep a prudent view on ratings of these products and consider they should not use the same scale as bond ratings.

Q27: Should further measures be taken to stimulate competition between CRAs overall and/ or in respect of the rating of particular types of asset class such as structured finance instruments? If so, please explain what measures could be taken without having a negative impact on the quality of credit ratings.

Confidence and credibility build up with time and not with regulation. We consider that they are where CRAs must and will develop competition spontaneously.

6.8 Other evidence

20. If there is any other evidence or information that you would like to bring to ESMA's attention, please present it here.

We consider that the regulation of CRAs is a very good step forward because of the systemic risk that results from a mechanistic reliance on ratings. However we feel that :

- The focus should be kept on the risk of excessive reliance on ratings and education of end investors;
- Regulation should address the question of contractual relationship between CRAs and not only issuers but also subscribers to their services; more specifically reporting under Solvency 2 raises very important questions that should not result in an excessive cost for asset managers, investors and, in the end, retail client;

- **Regulators should also consider the systemic risk that results from other information key to market stakeholders : data providers do present a systemic risk in our view and should be duly regulated in terms of organisation, responsibility and commercial approach.**