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# A.M. BEST EUROPE

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09 October 2013

Dear Sir / Madam,

### **A.M. Best – Response to ESMA Discussion Paper on CRA 3 Implementation**

I am writing to provide comments on behalf of A.M. Best Europe – Rating Services Limited (AMBERS) regarding the above discussion paper which was published by ESMA on 10 July 2013.

#### **1. Draft RTS on Information on structured Finance Instruments (Q1 -20)**

AMBERS does not currently provide ratings on Structured Finance Instruments and has no comments on this section.

#### **2. Draft RTS on the European Rating Platform**

As a general principle, AMBERS is supportive of enhanced information on ratings, outlooks and related actions. However, AMBERS would agree with the European Association of Credit Rating Agencies (EACRA) that an independent analysis of the existing reporting framework should be undertaken prior to the addition of new layers of reporting. In particular, AMBERS would stress the need to consider the frequency of reporting required in respect of SOCRAT data for smaller and medium-sized credit rating agencies (CRA). AMBERS' understanding is that ESMA uses SOCRAT data for "supervisory purposes" and that the frequency of reporting was developed by ESMA and is set out in Commission Delegated Regulation (EU) 446/2012. AMBERS has built a variety of processes to support the submission of SOCRAT data on a two-monthly basis but has, to date, never received any questions or feedback from ESMA on the data provided. Consequently, it would not appear that this data may not be being used to inform real-time supervision and therefore AMBERS would suggest that consideration should be given to the frequency with which such reports are required to be submitted.

**Q21 Particularly for users of ratings: Taking into consideration the rating classification described above, could you suggest (including a detailed reason):**

- a) other rating types not captured in the above categorization;
- b) which rating categories or rating components should ERP cover;
- c) other actions or events affecting the ratings, that should be published on the ERP.

Whilst this question is primarily directed at users of ratings, AMBERS would stress that the key overriding factor in determining whether a data item should be incorporated within the



proposed European Rating Platform (ERP) is that its inclusion can be supported by rigorous cost-benefit analysis. Every item of data included within the platform will require IT changes which will incur costs that impact smaller and medium-sized CRAs disproportionately. Therefore, ESMA should strive to avoid adopting a "shopping list" approach whereby every suggested item of data is included within the Platform. Instead each and every proposed item for inclusion should be carefully scrutinized and only included where there is a clear benefit to a significant number of the users of ratings which significantly outweighs the costs to the industry of providing that information.

**Q22 For displaying the press release information, which of the two options do you prefer and why? Particularly for CRAs can you provide evidence of the costs that you would incur under the two proposed options? Could you suggest other ways of retrieving, storing and make available on the ERP the press release information?**

AMBERS is not clear on what basis ESMA has determined that inclusion of press releases in the ERP is required to fulfill its legislative mandate and believes ESMA should clarify the basis for its conclusions on this point. Indeed, the simplest option would be to refer users of the platform to the respective CRA's website if additional information regarding the accompanying press release, underlying methodology or restrictions on the use of the rating is required.

However, assuming that ESMA's interpretation remains in place, AMBERS' initial view is that Option 1 is preferable and would represent the simplest, most cost-efficient and transparent solution to the perceived requirement. Option 2 would require additional manual resource to ensure the hyperlinks provided to ESMA remain correct which would appear to add additional costs into the process for no material benefit.

**Q23 Shall the ERP provide supporting rating information in addition to the press releases / report? If so what kind of information on the rating / rating action would be beneficial?**

AMBERS does not believe that CRAs should be required to provide additional information or indeed that such information would be beneficial. All data published by ESMA regarding ratings should be accompanied by a disclaimer that directs users of the ERP to the respective CRAs website for further information regarding methodology and any limitations on the use of the rating. Such a disclaimer will probably be necessary to provide appropriate protection to ESMA from liability claims arising from the inappropriate usage of ratings.

**Q26 Particularly for CRAs: which of the two possible ways of sending the new rating / outlook information to the ERP is more suitable to be integrated in your IT system: the real-time automatic data-feeds or one daily batch? Please provide a detailed motivation for your choice and include in your answer also reference to the actual costs that you would incur under the different submission options.**

All of the options outlined in the Discussion Paper have considerable impacts for CRAs in terms of both the content and frequency of the required data loads. For example, some of the required fields are not always currently available when a rating is finally approved within AMB and will require system changes.

In terms of frequency, all of the proposed options have drawbacks, but the task would be most manageable if the reporting was initially undertaken by way of a daily batch submission.



Starting out real time would have a significant impact on staffing requirements. Examples of additional costs would include monitoring, quality assurance, fixing reloads and data verification activity. In addition, there will be significant IT build costs as existing applications are updated to ensure compatibility with the platform and to ensure that ratings are not released until all of the relevant ESMA-required fields are updated.

AMBERS is not instinctively against real-time reporting but would suggest the more sensible and pragmatic approach would be to begin with an approach that required a daily submission of data with no press release link. Once that process is found to be operating effectively (and is demonstrably adding value), it would then be appropriate to consider moving to more frequent reporting.

**Q27 Can you suggest any other options for reporting the rating information to ESMA and for the publishing of the received rating information on the ERP?**

Conceptually the proposed ERP appears to be an application / database that is very similar to existing commercial applications / databases (e.g the Bloomberg application). Such applications already provide the capacity for investors easily to compare ratings in issue with regard to a specific entity or rated instrument. However, the limitation of such applications is that they currently do not include the ratings assigned by smaller agencies. Nevertheless, AMBERS would suggest that ESMA should give consideration to whether one of the existing commercial applications could be adapted as opposed to seeking to develop a new database from scratch.

**Q29 Particularly for CRAs: do CRAs envisage any difficulties on mapping your current internal identifiers with the new LEI for the rated entities?**

AMBERS currently has had limited exposure to the Global Legal Entity Identifier (LEI) initiative and so is unable to comment with certainty on the potential difficulties of mapping to the new LEI. However, some initial observations would be:

- The LEI appears to be essentially a G20 initiative. AMBERS currently provides ratings to a number of entities that are based in non-G20 countries and so may not have an LEI. Similarly, previous experience (e.g. CRA regulation) has demonstrated that individual G20 countries move at different speeds when it comes to the implementation of common initiatives and standards. Consequently clarity is required as to what mechanism is to be used where a CRA rates an entity without an LEI.
- The task of obtaining LEI data from existing clients should not be underestimated by ESMA. Some potential practical issues and considerations in this space include (but are not limited to):
  - The need to build processes to capture the LEI from the rated entities either through feeds from data filings or by manually requesting the data from entities as part of the rating process. Manually entering data fields of up to 20 characters carries a high risk of error and processes will need to be built within both CRAs and ESMA to validate the accuracy of LEI data.
  - The need for clarity as to what ESMA will require for companies that are no longer rated but do have a rating history.

**Q30 Particularly for CRAs: Are there other common issuer identifiers that the ERP could use in order to allow for a mapping of rated entities?**

Within the Bloomberg application referenced in the answer to Q27, there is an identifier field for all the rated entities they house.



**Q33 Particularly for CRAs: Would you agree with having just one individual data feed to ESMA in order to report to the ERP, CEREP and SOCRAT?**

AMBERS is conceptually supportive of any initiative that simplifies and enhances the efficiency of the existing reporting framework.

**Q34 Particularly for the users of ratings: do you agree with the proposed option? (Please state the reasons for your preference)**

Although this question is primarily directed at users of ratings, AMBERS would comment that there is an apparent inconsistency between paragraph 73 which indicates that the ERP will cover at least 11 years of rating data and paragraph 75 which indicates that data would only be required from November 2012.

**Q36 Are there any risks or implication with regard to mappings of rating scales in view of the distinct methodologies employed by CRAs? How should such risks be mitigated?**

**Q37 What features should a mapping of credit ratings have? Which methodology should be followed?**

AMBERS has a number of concerns regarding ESMA's proposals to undertake an additional mapping exercise over and above those that are currently undertaken as part of either the ECAI process or those which the European Banking Authority is currently undertaking in advance of CRD IV implementation.

Firstly, AMBERS is concerned at the confusion which could be created for the users of ratings by implementing numerous mapping processes with separate approaches and objectives.

Secondly, as the mapping exercise undertaken by the EBA is identifying, the single largest difficulty in seeking to map rating scales is the fact that each rating agency has a different definition of default. AMBERS' concern would be that the definitions used by the big three agencies (Moody's, Standard & Poors and Fitch Ratings) drive the definition and approach used by the mapping agencies in a way that unfairly penalises smaller and medium-sized CRAs. This would be a particular concern for AMBERS since, given AMBERS' single-sector approach within the insurance industry, its definition of default is fundamentally different to that of all other CRAs..

### **3. Draft RTS on Fees Charged by CRAs to their Clients**

AMBERS accepts that ESMA has been assigned a difficult task in seeking to implement this component of CRA3 given the fact that the legislation itself is fundamentally flawed. Indeed at a conceptual level, the legislation would seem to contradict the spirit of free trade which the European Union exists to promote and our opinion is that the measures will serve to significantly undermine competition within the CRA sector. However, whilst accepting the difficulties ESMA has faced in drafting this RTS, AMBERS has a number of serious concerns and would respectfully suggest that significant amendments are required.

AMBERS believes that the overarching intention of recital 38 of CRA 3 is to avoid situations whereby the rating issued to a client is driven by the fee the issuer is prepared to pay for that rating. AMBERS wholeheartedly embraces this principle and has in place policies and



procedures to prevent this from taking place.

In common with other CRAs, AMBERS' key control in this respect is that no individual involved in the analytical process has any involvement in the process for negotiating fees with clients and "Chinese Walls" exist to prevent analysts from becoming aware of fee information. Moreover, even if an analyst were to become aware of fee data, the Rating Committee process serves as a further control to prevent that information influencing the rating outcome. Consequently, if an analyst has no knowledge of fee discrepancies and is not involved in determining fees, the actual issue of how an individual fee has been determined is of absolutely no relevance to the integrity of the rating process. Given this reality, the additional measures outlined in this paper would appear to be superfluous. Moreover, it could be argued that the proposals being advanced in this Discussion Paper could actually serve to create additional conflicts of interest for Ratings Analysts. At present, analysts have no knowledge of the fees that are being paid by individual clients. However, by aligning the fee to the amount of work undertaken and respective cost incurred in the analytical work, a situation would be created in which analysts could identify the relative importance of clients within their portfolio.

AMBERS is not clear on what basis it is felt that the proposals within the Discussion Paper will help promote fair competition in the credit rating market. Indeed, AMBERS would argue that the proposals will serve to destroy competition by imposing a formulaic approach to pricing that will limit the flexibility of smaller CRAs to compete on price grounds.

The Discussion Paper references similar regulatory initiatives in the electricity and electronic communications markets. The fact ESMA has chosen to make such a comparison is concerning as the comparison is wholly inappropriate. Within the utilities sector, consumers have no choice whether they wish to use utilities such as gas and electricity. Consequently pricing regulation in the utilities sector exists to protect consumers from inequalities of bargaining power in what is essentially a compulsory purchase. This is manifestly not the case within the credit rating sector as the purchase is an optional decision made by corporate organisations. AMBERS is not aware of any other non-utility / public service sector industry in a free market economy where pricing regulation has been applied and indeed the very concept appears at odds with the free trade principles enshrined in EU legislation. Certainly no other CRA regulator has attempted to intervene in the pricing decisions of CRAs.

AMBERS also considers that ESMA makes certain fundamental assumptions regarding both price negotiation and internal costs which are unfounded and at odds with standard business practice. AMBERS competes for new business in a market environment and is seldom the sole determinant of price. The rating fee will depend on the negotiating parties' respective positions such as the potential client's need for a rating in its own commercial environment, the specific value it perceives to attach to the rating offered by different rating agencies and the capacity and keenness of rating agencies to win the business. AMBERS itself may attach variable strategic interest in securing a rating mandate for its own strategic reasons (e.g. securing a client in a new target market with a view to growing additional ratings in that market).

All such considerations and negotiations occur outside the analytical sphere and therefore have no impact on the rating process. Strategic / investment costs are a fundamental component of pricing and consequently, in order to ensure appropriate competition within the market, ESMA needs to ensure that flexibility is built into its proposals to ensure that CRAs can continue to incorporate such considerations in their pricing models. One possibility might be to mandate that CRAs follow established pricing models and must be able to justify why any additional discounts (other than economies of scale) have been applied. It may even be possible further to define a limited number of predetermined "investment costs" that might be permissible in justifying discounting.



From a practical perspective, the cross-geographical impact of ESMA's proposals are considerable. AMBERS is itself part of an international group and has clients similarly structured. On occasion, client companies request to negotiate a single group fee for all rating work and this may be invoiced by AMBERS or a fellow group company. The total of rating fee invoices rendered by AMBERS does not equal the total fee income of the company, as elements of client group fees are ceded to and received from fellow group companies. Consequently, ESMA's fee proposals will have, as yet unknown, implications for the pricing of ratings where AMBERS is impacted by, but not actually responsible for, fee negotiations.

An additional practical concern results from the reality that producing an interactive rating is not a certain or homogeneous practice. Internal costs can therefore only be estimated when fees are being negotiated with a prospective client, and the actual cost experience can vary significantly around this estimate. AMBERS requires all necessary resources to be made available to analysts in producing and maintaining their rating, irrespective of whether the originally estimated resources have already been expended. Clients want consistency in their fees before signing a rating agreement and it would therefore be unusual for a material re-pricing to take place after an initial rating, avoiding the impression of initial heavy discounting followed by major hikes in fees.

Due to these pricing and costing realities, unknown to the analysts determining ratings, differential profits result within a portfolio of clients but these in no way reflect discriminatory pricing based upon the level of rating achieved by a client.

**Q38 Do you consider that identification of "common practices" (within a CRA and across the CRA market) can help to identify discriminatory and non-discriminatory practices.**

As outlined above, AMBERS believes that the issue of discriminatory practices in connection with fee setting for a single rating service is irrelevant if there are appropriate controls to prevent analysts becoming aware of discrepancies in pricing between clients. As such, AMBERS does not believe the identification of "common practices" will materially strengthen the position.

Where there is price discrimination by agencies between multiple product offerings contracted to a single client, this can clearly distort the competitive market. If disproportionate profit can be made from one product in a less competitive arena and used to support lower returns in a more competitive product market, this is wrong irrespective of whether it is found to be a "common practice".

**Q39 Do you agree on the proposed periodic reporting illustrated above to be submitted by CRAs to ESMA on the application of their pricing policies and calculating their fees? Do you think there are other relevant criteria that should be included to allow ESMA to monitor the non-discrimination requirement?**

Given the volume of reporting already provided to ESMA and the minimal amounts of feedback this generates, AMBERS would be wary of adding another stream of reporting unless there is clarity as to what ESMA intends to do with the data it receives. Most issues might most simply be determined within policies, to which exception reports could be filed.

**Q40 What is the frequency with which such reporting should be provided to ESMA?**

For the reasons outlined above, AMBERS would suggest that no formal reporting is provided



to ESMA. However, if it is felt that some form of reporting is required, AMBERS would suggest this should purely be an annual requirement.

**Q41 Particularly to CRAs: what are the criteria you are applying or plan to apply to ensure fees are not discriminatory?**

As outlined above, AMBERS' opinion is that the issue of whether or not fees are discriminatory is irrelevant if there are appropriate controls to prevent analysts becoming aware of discrepancies in fees between rated entities.

As noted above, dissimilarity of profit achieved should be understood rather than considered prima facie evidence of discrimination.

**Q42 Do you agree on the approach to assess whether fees are dependent on the level of the credit rating issued by the credit rating agency or any other result or outcome of the work performed? Do you consider that other approaches or criteria should be applied? What cases do you think should be comprised in the concept "any other result or outcome of the work performed"?**

**Q43 Do you agree on the approach to assess whether fees are dependent on the provision of ancillary services? Do you consider other approaches or criteria should be applied too? Do you consider that a risk indicator (percentage) between ancillary services fees and the rating and follow-up fees from a rated issuer or any related party can help to identify possible discriminatory practices? If so, what percentage do you consider appropriate? What would you consider a significant percentage?**

As noted above, the realities of credit rating fee negotiation and cost management make comparison with the utilities market wholly inappropriate.

However, AMBERS would suggest that ESMA also needs to consider the dependency of the fee charged by some rating agencies and the purchase of additional rating services. For example, several larger firms will provide a financial strength rating for a minimal fee on the basis that they believe additional revenue can be obtained from the subsequent rating of debt or structured products.

CRA dependency on a client should focus on total fees of the CRA and CRA group to the client company and client group. This would best be reviewed by exception reporting above stated levels. The specific sources of revenue – multiple rating or ancillary services – would appear less relevant in creating the dependency.

**Q44 Particularly to CRAs: what are the criteria or practices you are applying or plan to apply to ensure fees are not dependent on the level of the rating issued by your agency or any other result or outcome of the work performed? What are the criteria or practices you are applying or plan to apply to ensure fees are not dependent on the provision of ancillary services?**

The primary control in place to ensure that fees are not dependent on the level of rating issued by AMBERS is the fact that those involved in the analytical process are not involved in the fee negotiation process and do not have access to fee information regarding our clients. Moreover, even if an analyst did become aware of a rating fee (e.g. the rated entity disclosed this information via its published Report and Accounts) procedures are in place to control the onward dissemination of that information, whilst the Rating Committee process provides a further mitigating control against the capacity for any individual to use such information to influence the rating.



AMBERS would caution that the reality for its clients is that those clients paying the largest fees tend to receive ratings towards the higher end of our range. The fee charged reflects the size and complexity of these clients and therefore the costs involved in rating these entities. However, these clients also tend to have the strongest capital positions and risk management frameworks which tends to drive higher ratings.

It should be noted that AMBERS does not currently receive any income from ancillary services.

**Q45 Particularly to CRAs: Do you have cost synergies between rating services and non-rating services other than ancillary services? In that case, please specify what these synergies are and how costs for non-rating and non-ancillary services are allocated to your rating services?**

Clearly, cost synergies will be available where multiple rating services are undertaken in respect of an issuer (e.g. debt rating assigned where there is an existing financial strength / issuer credit rating). In AMBERS' experience such synergies are not typically reflected in the pricing models of other agencies who will tend to charge for the debt rating using a basis-points approach.

**Q46 What are your views towards the approach that different business models and fee structures should be taken into account when assessing whether fees are cost-based?**

AMBERS agrees with the statement in paragraph 93 that there is not a single business model or cost structure in the CRA market. The list of factors set out by ESMA in paragraphs 95-97 is appropriate. However, as outlined above, the fundamental gap is an appreciation of the fact that discounts may also be applied as an "investment cost" (e.g. to obtain a key client in a target market, it may be necessary to operate discount-led pricing. Once a foothold has been established in a particular market, it would then be possible to increase fees back to market levels).

**Q47 What are your views on the above approach to CRAs' cost-structure? Do you consider other approach or criteria should be applied? If you agree with the above approach, what cost and non-cost components do you consider should be taken into account and periodically reported to ESMA to identify CRAs' fee structure?**

AMBERS is concerned that the level of detail being suggested by ESMA is vastly disproportionate. Instead AMBERS would suggest that no such reporting is provided to ESMA, but rather that such information is only submitted where there is evidence or concerns regarding treatment or as part of ESMA's programme of regulatory visits.

**Q48 Do you agree on identifying average costs per component, average cost per service and average costs per asset class in order to assess whether fees are cost-based?**

AMBERS does not agree with the approach outlined by ESMA. In particular, AMBERS is unclear how the complexities around costs will be determined. For example, if a first rating in a new territory is taken on that creates local costs (e.g. regulatory, legal or operational) must that first rating carry the marginal cost, or should the additional cost be apportioned over subsequent ratings in that territory (notwithstanding the fact that the subsequently rated entities did not actually occur the initial cost).



**Q49 What is the frequency with which such reporting should be provided to ESMA?**

AMBERS would question whether this information needs to be submitted to ESMA on a periodic basis. Instead AMBERS would suggest firms are required to maintain this information and to provide it to ESMA on request (e.g. as part of a supervision visit or in response to an allegation or concern).

**Q50 Particularly to CRAs: What is your current cost and fee structure? What are the relevant costs when issuing a rating? What are the criteria you are applying or plan to apply to demonstrate that fees are based on costs?**

All company costs, irrespective of their nature – client-facing or overhead, fixed or variable – need in aggregate to be covered by rating fee income. Profit absorbs the impact of competitive pricing pressure or under-estimation of costs. We review actual revenue and costs against budgets to ensure our business remains appropriately profitable.

AMBERS does not consider detailed time measurement and cost allocation to individual rating assignments to be a proportionate response to the need for fair pricing.

**Q51 Do you agree CRAs should periodically report to ESMA on the above list of information? Which frequency do you think it is more appropriate? Do you think any other information should be reported to ESMA?**

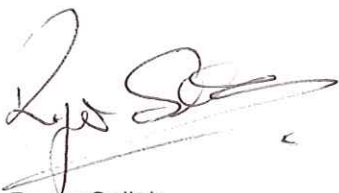
Please see the answer to question 49.

**Q52 Do you agree that CRAs should report on an “event-based” basis to ESMA when relevant deviations from their pricing policies occur? Do you agree that CRAs should report on an “event-based” basis to ESMA when ancillary services fees exceed a pre-defined percentage with respect to ratings and follow-up fees?**

Once appropriate pricing policies are established, CRA reporting to ESMA should be annual and by exception to the policies.

I trust that the above comments will be of value. Please do not hesitate to contact me should you require clarification on any of the points we have made or should you have any other queries.

Yours faithfully



Roger Sellek  
Chief Executive  
A.M. Best Europe – Ratings Services Limited

