Frankfurt am Main, July 16, 2021

Q3 Do you agree that the common understanding is reflective of your interactions with CRAs and would capture the broad spectrum of assessments that would be provided prior to assigning a credit rating?

According to ESMAs's Executive Summary, “Rating shopping can be understood as occurring when an issuer engages with a number of credit rating agencies with a view to selecting only those credit rating agencies that will provide the most favourable assessment for the entity or debt instrument.” This definition goes further than the spectrum of assessments described by ESMA and relates to even more situations observed in practice.

The acceptance of a rating order is preceded by a rough analysis. Reputable rating agencies check the issuer before an order of any kind is accepted from the issuer. Such a preliminary check takes place at the rating agencies, among other things, for business policy reasons and for reasons of resource planning. Working with a dubious issuer can damage the rating agency’s reputation even if it issues a low speculative grade rating.

The issuer's trick now is to publicly name a preferred rating agency and the desired rating result. The public announcement cannot be hidden from the targeted agency’s analysts. This puts the analysts under pressure to only accept the rating order if they can - no matter if rightfully or not - “justify” the desired rating. If they do not see this opportunity, the contract goes to another agency. This avoids even having to report on any of the assessments mentioned by ESMA, CRAs’ non-credit rating product offerings.

Issuers seem to have a lower risk of subsequently having to embarrassingly admit that the desired rating agency has not given the desired rating than the chance that the analysts will follow the request. This is especially true for smaller agencies that claim to be "the leading" in Europe and struggle to live up to their claim, since their market share is in reality small. With such a claim, the agency’s incentive to accept the rating order under all the conditions set by the issuer, is particularly large.

Q5 Do you agree that the information to be disclosed here will be of assistance in developing a clearer picture of which entities or instruments have been subject to initial review or preliminary rating? If you do not agree, please explain.

The proposal assumes good behavior on the part of the issuer, although it is precisely about the cases in which an issuer hides a poorer rating. The rating can refer to a shelf registration or any other vehicle with a different LEI or an instrument with a different ISIN, which can be legally differentiated, but represent the same economic risk. These cases are particularly difficult to grasp when the greedy rating agency also collaborates on behalf of the issuer against competing agencies.

It is even more complicated to discover cases of rating shopping when it comes to holdings. There is the case where the cash flows of one company are dependent on those of another company, but only proportionally. These cash flows are leveraged again. It is clear to the commissioned rating agency that it will only get the contract if it assesses the instruments based on these leveraged cash flows about as well as the instruments of the company rated by another agency from which the cash flows come. An investor only recognizes the interrelationships once he has carefully examined the register data. Theoretically, however, it would be the task of the rating agency to make this overview easier for him. In this case of rating shopping, the rating agency had no interest in disclosing the dubious circumstances of how it got the contract.

Q7 Do you agree that the proposed timing of these disclosures will better enable investors and the market to identify where rating shopping may have occurred? If you do not agree please explain.

The wise choice of the timing of publications is a differentiating factor between the rating agencies. Investors and issuers prefer agencies that know how to choose their publication times sensibly. Rating agencies compete with each other to choose the wisest possible time for publication, for example before or after the market closes, before, after or at the same time as other notifications, etc. It takes many years of experience to understand the complex constraints and interests of issuers (and their boards and shareholders), banks, law firms, auditors, rating advisors, institutional and private investors, etc. We see a certain risk of a race to the bottom due to the rigid setting of dates. The incentive to carefully prepare and adhere to the most appropriate publication times, weighing all interests, must not be dampened by bureaucratic processes.

Q8 Do you foresee any difficulties with the timing of these disclosures and the timing of your regulatory disclosures to the market?

There are examples in which rating agencies had to inform about new developments within a few days. Also to be considered are cases in which the issuer did not keep to agreements, such as not publishing a rating, so that the rating agency had to change the status of the rating at short notice.

As long as a rating agency retains the right to publish the information mentioned at any other point in time, the different qualities and priorities of the agencies should become apparent in the competition between the rating agencies. In this respect, the times mentioned should only be the "latest" deadlines.

Q9 What is the value of CRAs disclosing that they provided an initial review or preliminary rating in cases where a final public credit rating is ultimately not provided for an entity or debt instrument?

The leading agencies have achieved an astonishingly high level of disclosure of their criteria and methodologies. In addition, the frequent reports on the assessment of individual issuers make it very easy to get an idea of the strictness of the standards applied. If a rating is not published, investors receive valuable information about the fact that there may be a disagreement between the issuer and the rating agency about the rating to be issued. This can relate to questions of the volatility or stability of the rating history, the outlook and, of course, the rating category, among other things.

Just to provide one example in the following: A bank was given a rating year after year by a rating agency, but these ratings were never published. Then the bank adopted an irresponsible expansion strategy. The balance sheet total was multiplied within a very short time. This inevitably went hand in hand with the increase in the commitment of creditors, as well as with the expansion of the circle of creditors. Another agency was brought in to convince and reassure creditors with a high investment grade rating. The former representative of the shareholder of the first agency, but also the shareholder and advisory board member of the second agency, sat both in the supervisory board of the same bank. Therefore, a lively exchange could take place about which agency gives the excellent rating. The decision was made in favor of the new agency, whose shareholder could use his position both in the advisory board of the new agency and his chair in the supervisory board of the rated bank.

Although, due to the particularities of the national deposit guarantee system applicable, it could be assumed in this case that there was already an unpublished rating from another agency, there was no certainty of this fact until the government's response to a request from parliamentarians could unequivocally uncover the conflicts of interest. This government response did not help any creditor, because the bank had since gone bankrupt already. The questionable issues could have been determined in good time if all the people and agencies involved had been known beforehand. Since the new agency has already been sanctioned by ESMA in other cases, the reference to the long-standing but unpublished rating of the other agency would have been a clear indication, at least for knowledgeable professional investors.

None of the agencies involved in these deals has ever commented on the conflicts of interest. On the contrary, evidence of the dependencies has been deleted and information has been taken from the Internet. Since ESMA does not intervene either, this type of rating shopping practice can be continued successfully, to the detriment of investors who lose their money here.

It would also have been helpful to find out in this case that the bank's risk management had been outsourced to the new rating agency. This was another conflict of interest, since the same agency was responsible for the risk solutions and at the same time the same agency assessed how good the risk management it had carried out itself for the bank was. Here it would have been helpful to know that there was a rating from another agency at the same time, but only the rating of the agency with the massive conflicts of interest (shareholder, supervisory board, advisory board, customer for risk solutions, etc.) was published.

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Q11 Do you agree that centralising accessibility to this information will improve your ability to assess whether an entity or debt instrument has been subject to rating shopping? If you do not agree please explain.

Yes. It must not be left to the rating agency alone to save and publish the data. In order to understand the evidence for ratings issued, it is important to have an overview of a complete history. Unfortunately, through constant reorganizations, takeovers, changes in company forms, changes in numerous boards, such as supervisory boards, advisory boards, board of trustees, honorary board etc. and changes in personnel, attempts are made to disguise the true characteristics of a rating agency or to evade legal consequences such as liability. As evidence shows, a CRA might not hesitate to immediately delete evidence of existing conflicts of interest from its website as soon as a suspicion becomes public.

Q12 Do you consider there is value in ESMA providing a standardised disclosure template for these public disclosures? Do you have any additional comments on the standardised disclosure template?

For each rating, it should also be possible to offer a stable link to a page on the website of the rating agency from which all other related information that is available to the public or for subscribers can be reliably found. There is the example of a rating agency for which a search engine such as Google identifies different documents on the agency's website than those that can be found using the search function on the rating agency's website itself. This results in an uncertainty as to whether the documents found via search engines were merely "forgotten" to be linked and integrated in the website so that they can be found easily or whether they are draft versions or even coincidental, irrelevant uploads. Some posts and documents are not adequately marked so that, for example, simple things like the date of publication are missing. This makes the examination of cases of rating shopping difficult.

Q13 Do you have any comments on the preliminary cost benefit analysis?

ESMA does not mention important users of ratings here. Here are real-life cases: In various EU countries, also outside the euro currency area, minimum ratings are used by central banks in their money creation process. The noticeable feature here is that certain agencies issue a large number of precisely those minimum ratings that are necessary to be included in the purchase program.

Since in one case this money creation even takes place on an explicit agreement between just one rating agency and the central bank, it is to be feared that every mandate will be accepted by this agency and given the minimum rating (or better), regardless of the actual creditworthiness. For issuers it is easy to see that they can expect a better rating from the agency, which explicitly advertises with the agreement with the central bank. For investors it is therefore of great use to find out whether issuers are being passed through straight away to access central bank funding, or whether some receive an inadequate rating and therefore do not publish their rating.

The system guarantees the rating agencies an easy-to-generate return because those central banks use the ratings mechanistically. If there were only published ratings in these cases, that would be an indication of a possible abuse of the sluice function that the rating agency performs in accessing central bank money. Information on ratings carried out but not published would create trust. Cases of rubber-stamping would become more evident.

The rating agency signals to issuers its attractiveness for rating shopping, among other things, by adding veteran politicians and directors of central banks to their payroll. In this way, the rating agency creates the necessary trust with issuers that cases of rating shopping will not be exposed and not punished in any way.

ESMA foresees that its guidelines will benefit market participants. In view of the increasingly dominant role of central banks in the financial markets and their purchase of bonds in various purchase programs, the benefits for the European System of Central Banks (ESCB) should be given even more attention.

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