

31 March 2015

European Securities and Markets Authority  
103 Rue de Grenelle  
75007 Paris  
France

**Reply to Call for Evidence on  
Competition, Choice and Conflicts of Interests in the CRA Industry (ESMA/2015/233)**

Dear Madams/Sirs,

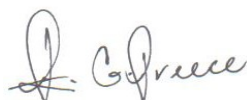
CFA Institute appreciates the opportunity to respond to the Call for Evidence on Competition, Choice and Conflicts of Interests in the CRA Industry (ESMA/2015/233) that ESMA issued as part of the development of Technical Advice for the European Commission on the functioning of the credit rating industry and the evolution of the markets for structured finance instruments as required by the Regulation on CRAs.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal of the Institute is to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 120,000 members in 150 countries and territories, including 115,000 Chartered Financial Analyst charter-holders, and 144 member societies.

By reason of the information sought by ESMA, CFA Institute has responded to selected sections of the Call for Evidence, in relation to the topics of (a) use of CRAs since 2010, (b) quality of credit ratings, (c) reliability of credit ratings, and (d) competition between CRAs. Our responses are based on the [member survey](#) we conducted on CRAs in June 2014.

Our responses to the Call for Evidence are set out in the attached ESMA response form.

Yours faithfully,



Rhodri Preece, CFA  
Head, Capital Markets Policy, EMEA  
CFA Institute

+44 (0)20 7330 9522  
[rhodri.preece@cfainstitute.org](mailto:rhodri.preece@cfainstitute.org)



Maiju Hamunen  
Analyst, Capital Markets Policy, EMEA  
CFA Institute

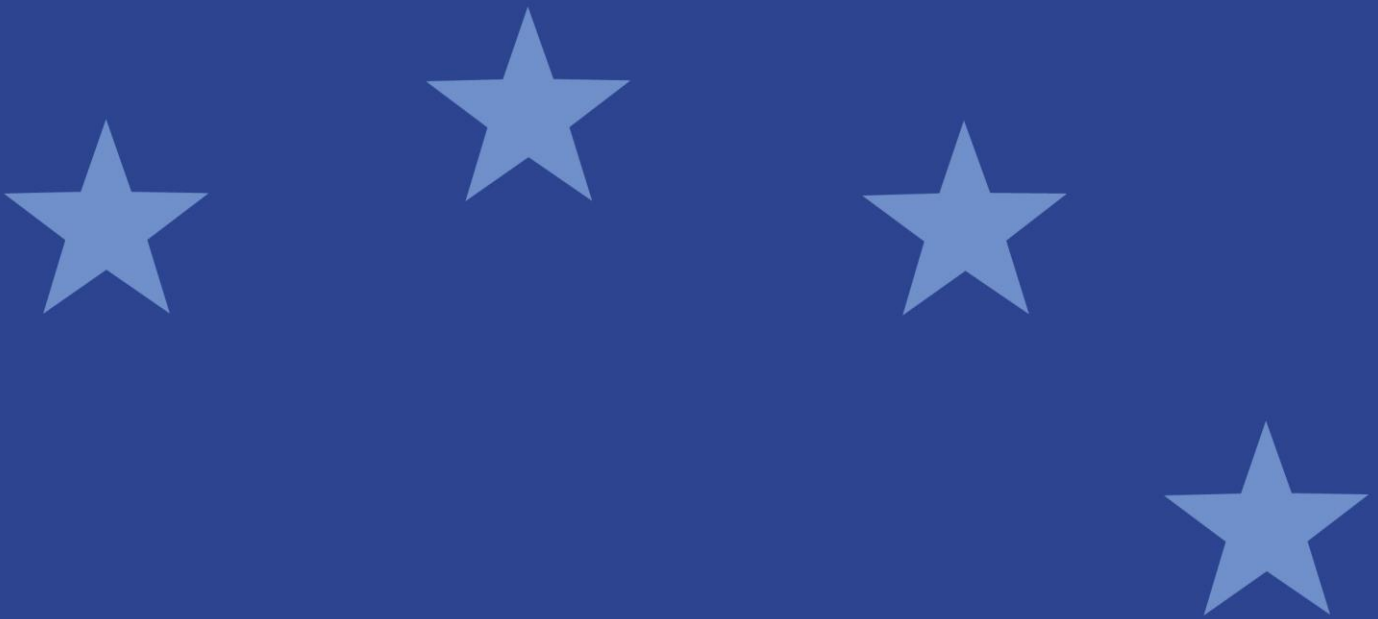
+32 (0)2 401 6828  
[maiju.hamunen@cfainstitute.org](mailto:maiju.hamunen@cfainstitute.org)



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](http://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](http://www.esma.europa.eu) under the heading [Legal Notice](#).

## Table of Contents

Acronyms used.....	4
Executive Summary .....	5
6 Questions for investors and other users of credit ratings .....	6
6.1 About your organisation .....	6
6.2 Due diligence and use of credit ratings.....	6
6.3 Independence and quality of credit ratings .....	8
6.4 Multiple credit ratings .....	10
6.5 Disclosure requirements for structured finance instruments .....	11
6.6 Mandatory rotation .....	12
6.7 Competition between credit rating agencies .....	13
6.8 Other evidence.....	14



## 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.**

**CFA Institute.**

**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.**

**CFA Institute is a not-for-profit professional organisation representing investment professionals. CFA Institute is therefore not a direct investor but represents professionals who do invest.**

**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.**

**CFA Institute is a not-for-profit professional organisation representing investment professionals. CFA Institute is therefore not a direct investor but represents professionals who do invest.**

### 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.**

[Click here to enter text](#)

**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.**

[Click here to enter text](#)

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

[Click here to enter text](#)

**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.**

[Click here to enter text](#)

**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**

[Click here to enter text](#)

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

[Click here to enter text](#)

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

[Click here to enter text](#)



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

[Click here to enter text](#)

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

CFA Institute conducted a member survey on CRAs in June 2014. 67% of our members in the Europe, Middle East and Africa (EMEA) region noted that since the financial crisis, investors have become more cautious regarding how/if they use CRAs in their investment process. That view was also echoed in the open comment section of the survey.

Most of the respondents maintained that there has always been too much trust in the ratings, and that instead of blindly relying on the CRAs assessments, investors should do more independent analysis to support the CRAs assessments.

One respondent summarised the problems since 2007 as the following: *'understaffing, poor leadership, poor research, too many administrative demands placed on the analysts'*. Nonetheless, the same respondent noted that *'the value of experience - surviving the 2008 crisis - has helped the buy side become more cautious in the use of ratings'*.

According to our survey, investors have become more aware of both the benefits and limitations of CRAs since 2010. This is a welcome development. We believe that CRAs provide a valuable service and that credit ratings are a key component of credit risk assessment and due diligence processes. However, the role of CRAs is not to replace investors' due diligence processes and there should not be mechanistic reliance on CRA ratings.

### **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.<sup>1</sup>
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.

**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.**

[Click here to enter text](#)

---

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

**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.**

[Click here to enter text](#)

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

CFA Institute conducted a member survey on CRAs in June 2014. Opinions were divided among investment professionals whether the quality of credit ratings has improved since 2010. In the survey, 36% of our members agreed and 31% disagreed with the statement that the reliability and quality of credit ratings has improved since the financial crisis.

According to one member, the biggest improvement in the credibility of CRAs is the *'widespread public acknowledgment'* that the challenges of 2008 *'have created an environment that is conducive to using a rating as one opinion, rather than an indisputable litmus test as to the safety of an investment'*.

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

CFA Institute members proposed in our June 2014 member survey several means to increase the quality of ratings. Most of our members (61% of respondents in the EMEA region) noted that the most important thing would be to change the **issuer pays** model. Only 2% of all EMEA respondents believed that the issuer-pays model has the fewest, or least problematic, conflicts of interest.

Currently there is a lack of CRAs that operate the investor-pays business model. The lack of diversity in business models is a concern. Nonetheless, we do not believe that it is appropriate for regulators to prescribe, or to favour, one business model over another.

As to the alternatives to the issuer-pays model, our members were split between the investor pays model and the creation of a 'hybrid model' with a flat fee.

Nonetheless, 59% of our respondents in EMEA stated that all rating agency models have conflicts of interest – it would be better to increase transparency and competition and let investors decide which model does the best job. As one of our respondents put it, *'the only way to truly improve the reliability of credit ratings is to remove them from any investment policy. As long as investors are forced to use ratings they will always be an issue'*. CFA Institute members (61% of respondents in EMEA) also maintained that increasing transparency around the way ratings are established would improve the reliability of CRAs.

As to other means to increase the quality of ratings, 23% of the EMEA respondents believe that increased regulation on CRA processes would have the biggest positive impact on the reliability of credit ratings. 21% of the EMEA respondents believe that the removal of regulatory and statutory requirements for financial firms to rely on the ratings of CRAs would have the biggest impact on reliability.

CFA Institute acknowledges that steps have already been taken via the CRA Regulation in the EU to tackle conflicts of interest and to increase transparency. We also acknowledge that there have been measures to remove mechanistic reliance on credit ratings. We support these developments.

## 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.<sup>2</sup>
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.**

[Click here to enter text](#)

**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.**

[Click here to enter text](#)

---

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

**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.**

[Click here to enter text](#)

**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.**

[Click here to enter text](#)

## **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 tranching, 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'.<sup>3</sup>*

12. Commission Delegated Regulation 2015/3 of 30 September 2014 sets out the disclosure requirements for issuers, originators and sponsors of structured finance instruments.<sup>4</sup> 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.

---

<sup>3</sup> 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.

<sup>4</sup> OJ L 57, 6.1.2015, p. 2.

**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.**

[Click here to enter text](#)

## **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.<sup>5</sup>

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.<sup>6</sup>

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.**

[Click here to enter text](#)

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

---

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

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

[Click here to enter text](#)

**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;**

[Click here to enter text](#)

**(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.<sup>7</sup>**

[Click here to enter text](#)

**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.**

[Click here to enter text](#)

## **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.

---

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

**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).**

[Click here to enter text](#)

**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.**

Most respondents to CFA Institute's June 2014 member survey supported the generation of further competition between CRAs. There were over 20 open comments supporting further competition, and one against. Nonetheless, only 6% of EMEA respondents stated that increased competition from new rating agencies would have the *biggest* (emphasis added) impact on the reliability of credit ratings. Increased competition is thus important, yet it is not the single most important measure to increase the reliability of credit 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.**

[Click here to enter text](#)

## **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.

[Click here to enter text](#)