30 March 2015

European Securities and Markets Authority
103 rue de Grenelle
75345 Paris
France

Submitted online: www.esma.europa.eu

Dear Sir or Madam,

ESMA – Call for Evidence– Competition, choice and conflicts of interest in the credit rating industry

On behalf of the Association for Financial Markets in Europe (AFME)\(^1\) and its members, we welcome the opportunity to respond to the above Call for Evidence published by the European Securities and Markets Authority (ESMA).

Because AFME is a trade association and not a corporate or sovereign issuer, credit rating agency or investor or other user of credit ratings, our response is filed in the form of a letter. In particular, we respond only to the questions listed below, which refer to the “issuer” section of the Call for Evidence but the points we make have general application.

Q12. Please explain whether there are other models which would allow CRAs to seek payment for the credit ratings they issue, giving reasons for your answer.

Alternatives to the most widely used “issuer-pays” model can be envisaged which would allow CRAs to seek payment for the credit ratings they issue. We analyse these below.

However, as with many other business models and industries in which inherent potential for conflict exists, we believe that the appropriate approach is to ensure that potential conflicts are well managed and subject to regulatory oversight. Experience in practice suggests that "issuer-pays" conflicts can be managed by effective governance structures and successful segregation of functions and information within an entity. Considerable reforms have taken place in recent years to address this, and examples of CRAs' policies and procedures to pre-empt and manage conflicts are outlined below.

The CRA Regulation supports and formalises the basis on which conflicts should be managed. We believe that any potential conflicts under the “issuer-pays” model are already being managed appropriately. Accordingly we do not believe that alternative models or new regulatory standards are necessary. Existing standards are supported by international consensus in the form of the IOSCO code and already reflect best practice for conflicts management.

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\(^1\) AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.


AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.
“Issuer-pays” and alternative models

While in principle the "issuer-pays" model can distort behaviour of CRAs and the market given the inherent conflicts of interests involved, the same is true for any other model in which a stakeholder in the rating process pays. No consensus has been reached by authorities or commentators on a superior alternative to the status quo. We believe that it is important for the European regulatory regime to continue to support a plurality of business models and maintain a level playing field for CRAs based on market demand. Regulators should not legislate to reduce or prohibit use of the "issuer-pays" model where conflicts of interest can be shown to be managed effectively, and there is no compelling evidence to suggest that alternative models would be more effective. All of the alternatives to the "issuer-pays" model create their own issues in terms of feasibility and/or greater scope for conflicts, as explained in further detail below.

Subscriber/Investor pays model

This model would need to be in a form such that investors are required to subscribe to one or more agencies before being allowed to purchase. Such a requirement would be likely to reduce demand for such securities (given the additional cost associated with their purchase). It would also be likely to result in greater reliance by investors on CRA ratings, given the direct contractual nexus between the CRA and the investor. Furthermore, it would require multiple CRAs and we do not believe that the additional expense to investors and the market would not be justified on cost-benefit grounds.

An "investor-pays" model would also be vulnerable to conflicts of interest, since large institutional investors could distort the market by incentivising CRAs to rate assets in their portfolios favourably to make them more attractive. This would be particularly so if only large institutional investors were prepared (or required) to obtain and pay for a rating, which could make them the only source of income for CRAs. There would also be difficulties with keeping ratings private and preventing "free-riding" by other, non-paying investors. Such a model would not encompass non-EU investors and, we do not believe that the additional expense to investors and the market would not be justified on cost-benefit grounds.

Payment upon results model

This fundamentally misunderstands the process of credit ratings and imposes significant and unjustified restrictions on CRAs' economic model. It would be likely to increase the overall costs associated with ratings considerably, particularly given the cost of establishing a body responsible for independently monitoring and evaluating "performance" of ratings in order to determine the fees that should be payable to CRAs (assuming that this could not be established by CRAs' clients for conflicts reasons).

Trading venue pays model

This arguably does not mitigate any potential conflict (as issuers choose trading venues), and trading venues would in any case be unable to absorb the prohibitive costs associated with obtaining ratings for all traded instruments unless they were able to pass them on to issuers. This would be unworkable for non-listed issuers or instruments, which would have to be funded by an alternative model and furthermore could lead to inconsistent standards and practices for listed and non-listed issuers/instruments and create opportunities for regulatory arbitrage.
Government as hiring agent model

We note the acknowledgement by the US authorities of the practical difficulties associated with such an approach (as proposed under the so-called "Franken amendment" to the Dodd Frank Act), particularly with respect to the criteria and procedures governing the hiring process, which we agree would be very difficult to determine. We refer to the submissions to the US Securities and Exchange Commission dated September 13th, 2011 made by AFME and our sister association SIFMA on this topic, and note that in the years that have intervened since then we are not aware that any action has been taken to implement such an approach.

Public utility model

There would be no guarantee that the involvement of the public sector would result in better ratings, though the likelihood of this would be increased by devoting substantial funding and expertise to any validating body. The creation of publicly subsidised and/or administered models also has the potential to create “moral hazard”, distort the market and compromise the independence of ratings.

A validation framework which allows an EU or state-subsidised entity to "approve" individual rating decisions would sit uncomfortably with the requirement at Article 23 in the CRA Regulation that public authorities of Member States should not interfere with the content of individual ratings, even in the context of ostensibly validating the methodologies employed by CRAs. It would be more effective and appropriate for resources at a European level to be focused on effective monitoring and enforcement of the regulatory framework underpinning the ratings process than on attempting to validate the integrity of individual decisions.

Q21. Please provide details of any experience you have had of this rotation provision to date. If you have had experience with this provision, please provide an estimate of your costs of complying with it to date.

AFME members have very limited experience given the short time that has elapsed since the introduction of mandatory rotation, but our original serious concerns remain

As ESMA will be aware, the mandatory rotation requirement has only applied since 20 June 2013. Given this fact, and that the requirement provides that the application date should be used as the start date for calculating the maximum four-year term for previously existing rating arrangements, AFME members simply do not yet have any meaningful direct experience of applying the rotation requirement. It should also be noted that regulatory capital and other disincentives to discourage issuance of re-securitisations have been in place for some years (and since before the application date for mandatory rotation) such that, unsurprisingly, fewer new re-securitisation transactions have been issued in recent years. Against this backdrop, it is likely to take several more years for any meaningful experience to be gained by market participants under the requirement.

Notwithstanding this very limited direct experience, AFME members are of course familiar with the mandatory rotation requirements, having sought to participate in discussions about the requirement since the relevant original amendments were first published by the European Commission in November 2011. It should especially be noted that the Commission’s proposals were published at that time without prior formal consultation with the industry. Indeed, throughout such discussions AFME members consistently tried to raise awareness with respect to the significant and serious concerns which arose from the rotation requirement. While the severity of these concerns was reduced somewhat by the limited application of the final requirement to the market sector of re-securitisations only (rather than applying to securitisations more
broadly, or indeed debt instruments in general, as was originally proposed), this served only to contain rather than address the fundamental problems with the concept of mandatory rotation.

To be clear, in keeping with views repeatedly and strongly expressed at the time, AFME members regard mandatory rotation to be highly flawed in principle and do not consider such a requirement to be either appropriate or necessary – whether for re-securitisations, securitisations more broadly or for debt instruments generally. Indeed, AFME members do not consider that the case for applying rotation to re-securitisations (or indeed to structured finance instruments) has ever been made.

The Commission has previously indicated that mandatory rotation is intended to reduce potential conflicts of interest in the rating process and to improve the independence of rating agencies.\(^2\) We are not aware of any evidence that concerns sufficient to justify such a proposal exist around conflicts of interest in a structured finance context. Even more so today, any widening of the application of mandatory rotation outside its current scope of re-securitisations only would send a very negative signal, and would in our view be wholly inconsistent with the high level policy objective, endorsed by President Juncker and Commissioner Hill to revive the securitisation markets in Europe and to widen and deepen Europe’s capital markets more generally through building a stronger capital markets union.

Lastly, to the extent that the rotation requirement is intended to result in an increase in the number of rating agency options for rating relevant arrangements, we would note that, based on the market share calculations document published by ESMA in December 2014,\(^3\) there are only three “small” credit rating agencies registered at this point which have indicated that they are able to provide ratings in respect of structured finance products and it is not clear that these agencies have any experience in the context of re-securitisations.\(^4\)

Even in the context of its existing application to re-securitisations, we have additional concerns about the application of mandatory rotation which also seems highly unlikely to reduce conflicts of interest in rating arrangements

As noted above, AFME members have consistently expressed general concerns about the concept of mandatory rotation in principle. These concerns are outlined in our response to Q23 below.

In addition, we would like to stress that even in the limited context to which mandatory rotation already applies, namely only to re-securitisations, we have additional concerns. These stem from the fact that the current form of the rotation requirement reflects last-minute changes which were made to it before passing into law, as well as the lack of any consultation process with the industry. This is therefore the first formal opportunity that market participants have had to comment on the requirement as adopted.

Essentially, the requirement adopted in article 6b of the CRA Regulation is unclear and based on flawed assumptions about the nature of re-securitisations and the corresponding rating arrangements. Accordingly, AFME members consider the requirement to be highly unlikely to operate as intended.

The requirement seeks to restrict an agency engaged to rate a re-securitisation involving securities backed by underlying assets from a particular originator from rating new re-securitisations with underlying assets from the same originator beyond a maximum period of four years and expressly permits ratings issued during the maximum period to be maintained. As a result, the focus of the restriction is on the rating by the same agency of new re-securitisations involving underlying assets from the same originator at any time during the required “spelling off” period. This seems to assume that re-securitisations are defined in some manner by the involvement of a particular originator and/or that an originator will have a role in the rating arrangements


\(^4\) These agencies are Creditreform Rating AG, DBRS Ratings Limited and Scope Credit Rating GmbH.
in respect of a re-securitisation. However, this is not the case; these assumptions therefore do not reflect common arrangements in the market.

It may assist to provide some background. Re-securitisations can be structured in a number of different ways and the definition can include a variety of arrangements. However, in simple terms, a re-securitisation involves a pooling and re-tranching of the credit risk of a portfolio of previously issued asset-backed securities, which will often be sourced from various different underlying securitisation transactions. As a result, a re-securitisation may not involve the active participation of an underlying originator. Indeed an originator may not even know that securities backed by its assets have been included in a re-securitisation, or that such re-securitisation has been rated. Further, such transactions may involve securitisation positions backed by assets from a number of different underlying originators – who may also change over time. Therefore, the focus in the rating process on the identity of the underlying asset originators may be minimal.

Moreover, an originator of underlying assets in respect of a portion of the underlying asset-backed securities is highly unlikely to be involved in the rating arrangements in respect of the re-securitisation and, in keeping with this, will not enter into any sort of “umbrella” rating agreement with an agency for the rating of any re-securitisations involving securities backed by underlying assets originated by it. As a result, it is not at all clear how the rotation requirement as currently drafted may be sensibly applied. Nor is it clear how it would operate to reduce any conflicts of interest in the rating process, as it is not clear how any conflicts of interest would arise with respect to an originator.

Given firstly the nature of re-securitisations, secondly their usual lack of connection to underlying originators and thirdly that a number of securitisation positions may be included within them, the current focus in the rotation requirement on originators may lead to a scenario where none of the rating agencies which typically rate structured finance instruments is permitted to rate new re-securitisations involving securities backed by assets from one or more large originators. For example, this scenario could arise if all of the major agencies rated at least one re-securitisation involving underlying assets from such large originators as at the application date, as each of the agencies would be required to spell off after a maximum period of four years. Given the highly technical nature of the rating analysis undertaken in a re-securitisation context, the likelihood of new, smaller, and perhaps regional, rating agencies filling the void seems low.5

We also have significant technical concerns about the exemption described in article 6b(2), which we outline below in our response to Q24.

*Corresponding compliance costs are uncertain*

In light of the limited experience of market participants to date and the confusion described above about the application and operation of article 6b as adopted, we are unable to provide the requested costs information.

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

As noted above, AFME members have significant concerns about fundamental aspects of the mandatory rotation requirement. These concerns relate to mandatory rotation in principle and also to the specifics of the requirement as adopted in article 6b of the CRA Regulation. Accordingly, the current four year maximum period is seen by AFME members as being just one element of what is in our view a highly flawed legislative requirement.

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5 As noted above, there are only three “small” credit rating agencies registered at this point which have indicated that they are able to provide ratings in respect of structured finance products and it is not clear that these agencies have any experience in the context of re-securitisations.
That said, if a mandatory rotation requirement is to continue to apply in its current form (notwithstanding our significant concerns), then we would note that we are unable to identify a different maximum period that would be more appropriate. If the requirement is extended to other products and/or revised to operate in a different manner, then a different “on” and “off” period may be appropriate.

Lastly, the reference to a “four-year contract term” in this question is confusing as it appears to suggest that the contract entered into by a rating agency for rating a re-securitisation may not exceed four years. This appears to be based on the incorrect assumptions about re-securitisations outlined above and further suggests that the rating provided pursuant to the relevant contract may not be maintained beyond the maximum period. Pursuant to article 6b(4), it is our understanding that any ratings issued during the maximum four year period (pursuant to the original contract or to any other contract entered into during that time in respect of a relevant new re-securitisation) may be maintained on a solicited basis for the life of the transaction. Accordingly, AFME members consider that the four year term is the period during which ratings on relevant new re-securitisations may be issued and not the maximum period of any contract term per se. If ESMA interprets the requirement differently, then members would be keen to discuss this further.

Q23. Please explain whether mandatory rotation should be extended to other asset classes.

As noted above, AFME members regard mandatory rotation to be highly flawed in principle and do not consider such a requirement to be appropriate and/or necessary – for re-securitisations or for debt instruments more generally. Any extension of mandatory rotation from its current scope would risk significantly hindering any revival of the European securitisation market, and also damage efforts to build a strong capital markets union – both of which are today high level policy objectives of the Commission.

In particular, AFME members are concerned that mandatory rotation:

- interferes with the informed and sophisticated free choices of issuers and investors – the freedom of buyers of goods or services to choose their preferred sellers is critical to the free functioning of the internal market. This is as true in the context of credit ratings as in any other market sector. While we welcome new entrants and more competition, this should be allowed to develop naturally in response to the demands and requirements of issuers and investors. This is a long-term process, but is by no means impossible, as history has shown. We believe that it is wrong in principle to impose, through legislation, prescribed choices on issuers and investors. We believe that a better approach would be to continue work towards reducing reliance upon the use of credit ratings within the EU regulatory framework as this may assist in creating opportunities for a wider range of credit research and opinion providers, allowing such providers to compete on the basis of the quality and performance of their product;

- risks damaging the quality of ratings – rotation ignores the necessary commitment that both issuers and rating agencies must make in solicited ratings in order to ensure proper understanding not only of the issuer but also of its industry, the position of the issuer within that and applicable internal policies – particularly financial, underwriting and risk management policies. Rotation disregards the value of the necessary continuity in the monitoring of the issuer and its business sector. Forcing an issuer to rotate out a rating agency may therefore lead to the involvement of an agency without the necessary experience and reputation to provide a sound analysis. It may also lead to the involvement of agencies not recognised or accepted by investors under their permitted investment guidelines, reducing market stability and damaging liquidity. Moreover, mandatory rotation creates a disincentive for rating agencies to compete on the basis of analytical quality as competitors will simply have to “wait their turn” in order to win business; and

- will give rise to uncertainty and rating volatility – ratings are not a commodity product – methodologies are sophisticated, and different from each other. Rotation ignores this and assumes
all ratings are the same. Forcing an issuer to rotate from one rating agency to another with a different methodology creates a high risk that the change of agency, in and of itself, will cause the rating also to change. Also, the change of agency may require changes to be made to already negotiated and binding transaction documents which may not be acceptable to all parties, and may give rise to greater (and, in a structured finance context, unmodelled) costs. This may arise where, for example, the new agency has different counterparty requirements for, say, a swap provider. It is – to say the least - a major undertaking to change a counterparty in a securitisation transaction during its life; indeed a note holders’ meeting would likely be required and there would be no assurance that the consent of sufficient note holders would be forthcoming. Mandatory rotation may also lead to issuers (which currently have two or three credit ratings) reducing the number of their solicited ratings over time, rather than replacing agencies that have been required to rotate out.

To be clear, the concerns that AFME members have in respect of mandatory rotation would be increased significantly if the scope of application of article 6b was extended to any other products. Concerns in addition to those set out above may arise depending on the nature and detail of any extension and the relevant asset classes involved.

AFME members note that there was some discussion in 2012 of whether the mandatory rotation requirement should be applied to ratings in respect of structured finance instruments in general. It was suggested at that time that this was justified on the basis that this was an area in which the rating agencies had made major mistakes. AFME members do not consider that this view is accurate for Europe, where ratings performance of the major rating agencies has generally speaking been very good. Indeed, the credit performance of European structured finance has been excellent, with the vast majority of transactions performing within original expectations. While some downgrades have occurred due to deterioration of pool performance, sovereign risk factors and tightening of rating agency criteria (especially with regard to counterparties) have also played a role.

To be clear, AFME members are strongly opposed to an extension of the mandatory rotation requirement beyond re-securitisations to structured finance instruments more generally. While there is increasing focus in Europe and elsewhere on differentiated regulatory treatment for “qualifying securitisations”, and AFME members are supportive of this development in general, we do not consider mandatory rotation to be a suitable area for this distinction to be made. We can see no justification for the application of the requirement to structured finance instruments, regardless of whether or not the relevant arrangements satisfy any future “qualifying securitisation” requirements.

Lastly, we note that the application of mandatory rotation requirement may give rise to other prudential and regulatory considerations, and the potential considerations in this regard will turn in part on the products within the scope of application. For example, in the context of structured finance instruments in general, paragraph 71 the revised Basel securitisation framework requires eligible rating agencies for regulatory capital purposes to have “demonstrated experience in assessing securitisations, which may be evidenced by strong market acceptance”. This requirement (which we assume will eventually form part of the European regulatory capital regime) does not fit well with a requirement which forces an issuer to change agencies, possibly with the result that a less established and less skilled agency takes over increasing prudential regulatory concerns.

Furthermore, we note that structured finance instruments are generally required under article 8c of the CRA Regulation to have two ratings (and provisions also apply under the Solvency II regime which create incentives in this regard). Mandatory rotation presents heightened considerations in this context, particularly for certain types of asset-backed securities where only one or two rating agencies may be perceived to have the most appropriate expertise. This is because the rotation requirement may operate in combination with the double rating obligation to place further stress on the practical ability to rotate and may effectively restrict the involvement of the most appropriate rating agency/agencies for the product at certain times. While significant difficulties have not yet arisen in connection with current article 6b (which of course applies only
to re-securitisations, which are structured finance instruments subject to article 8c), this is largely due to the limited number of new re-securitisation transactions in recent years.

Additional regulatory considerations may arise in respect of other products.

If so, please:

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

As noted above, AFME members do not support any extension of the mandatory rotation requirement and consider that such a move would both hinder the recovery of Europe’s securitisation market and damage progress towards capital markets union.

(2) estimate the cost to your business of complying with the extension to each additional asset covered in your response in question 23(1) above:

In the absence of details with respect to how any mandatory rotation requirement would be applied to other products, it is not possible to anticipate the corresponding costs.

Notwithstanding the foregoing, it should be noted that if the rotation requirement is extended to other asset classes and applied in a manner which requires a change in the agency rating a particular instrument or entity, we would expect this to give rise to significant costs for market participants (and to lead to rating volatility in general). As noted above, a change of agency may require changes to be made to negotiated and binding transaction documents which may not be acceptable to all parties, and may give rise to greater (and, in a structured finance context, unmodelled) costs. This may arise where, for example, the new agency has different counterparty requirements as described above. More generally, we would note that start-up costs associated with new ratings engagements are typically high, which imposes additional burdens on issuers, without obvious benefit.

Before contemplating any extension of mandatory rotation outside its current scope, we strongly encourage the European authorities to undertake a proper impact assessment of the possible consequences, based on sufficient information such that the full costs and benefits can be determined.

(3) 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:

Forcing an outgoing rating agency to hand over its file to an incoming agency gives rise to concerns for issuers because the relevant file may include confidential information that the relevant issuer has disclosed to the outgoing agency, and the issuer may be less comfortable disclosing this to the incoming agency. This may create incentives for issuers to withhold information from rating agencies, which runs the risk of damaging the quality of ratings.

In addition, rating agencies may be less inclined to maintain a comprehensive file if they will be required to provide the file to a competitor.

While it is appreciated that provision of a handover file may reduce the start-up work (and possibly corresponding costs) associated with an incoming rating agency, AFME members consider that this requirement raises its own concerns and reflects the problematic nature of mandatory rotation in general. There is an obvious prudential concern around enabling an incoming rating agency to rely on work done by its outgoing competitor, as it would seem most prudent for an incoming agency to undertake its own credit analysis afresh.
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.

AFME members support the provision of an exemption from the mandatory rotation requirement, however, the current exemption presents a number of challenges from a practical perspective. These challenges arise primarily as a result of the references to, and intended reliance on, information to be provided by the “issuer”. This term is defined in the CRA Regulation to mean an issuer as defined in the EU Prospectus Directive, and extends to the legal entity which issues the securities.

By way of background, as in other structured finance transactions, the issuer in a re-securitisation will be a special purpose vehicle without operations and/or employees. The issuer will function through the contracted actions of its service providers only and will be restricted from undertaking activities not contemplated by the transaction documents. In general, there will be no connection between the issuer of the re-securitisation and any underlying originator. To be clear, the issuer will exist solely for the purposes of facilitating the relevant re-securitisation transaction and will not have a connection to any other re-securitisations. As noted above, the originator itself may not even be aware of the fact that asset-backed securities backed by assets originated by it have been included in a re-securitisation.

Based on the foregoing, the issuer will not be in a position to make the determinations contemplated by article 6b(2). Given its nature, the issuer will not have the ability to take steps to obtain this information and indeed it is not clear that this information could be assessed (by any party) in any event, given that re-securitisations may be undertaken on public or private basis.

As a result of the matters noted above, we consider it to be highly unlikely that the current exemption will operate as intended. Indeed, in practice, we think that rating agencies will need to proceed on the basis that the relief does not apply as the relevant information to determine otherwise will not be available.

In closing, we note that the engagement of ESMA with market participants on issues related to credit rating agencies is appreciated, as is the opportunity to respond to the Call for Evidence. We urge ESMA to take note of the key concerns outlined in this letter and reiterate that any widening of the application of mandatory rotation outside its current scope would send a very negative signal, and would in our view be wholly inconsistent with the high level policy objective, endorsed by President Juncker and Commissioner Hill to revive the securitisation markets in Europe and to widen and deepen Europe’s capital markets more generally through building a stronger capital markets union.

If you have any questions please contact the undersigned.

Yours faithfully,

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