Call for Evidence Investor Response

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

3 February 2015 | ESMA/2015/233

Responding to this call for evidence

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

1. Corporate and sovereign issuers of financial instruments requesting credit ratings.

2. Credit rating agencies issuing credit ratings.

3. Institutional investors and other users of credit ratings.

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

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

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

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

Publication of responses

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

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

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Acronyms used

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

Executive Summary

Reasons for publication

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

Contents

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

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

Next Steps

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

6 Questions for investors and other users of credit ratings

6.1 About your organisation

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

Q1: Please provide the name of your organisation.

Norges Bank, its investment management division Norges Bank Investment Management (NBIM).

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.

Norges Bank invests in fixed income instruments with credit rating at global level.

The following jurisdictions are covered:
United States, Japan, Germany, United Kingdom, France, Canada, Spain, International Organisations, Australia, Mexico, South Korea, Sweden, Italy, Netherlands, Switzerland, Brazil, India, China, Turkey, Finland, Poland, Belgium, Russia, Austria, Indonesia, Thailand, Denmark, Chile, South Africa, Singapore, Malaysia, Israel, Colombia, Taiwan, Hong Kong, Czech Republic, New Zealand, Philippines, Slovenia, United Arab Emirates, Ireland, Hungary, Slovakia, Portugal, Luxembourg, Bulgaria, Peru, Lithuania, Qatar, Iceland, Panama, Latvia, Uruguay, Croatia, Bahamas, Bermuda, Estonia, Greece, Trinidad and Tobago, and Cayman Islands.

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.

Norges Bank is invested as follows (per 31.12.2014):

- the Government Pension Fund Global: Moody's Corp (0.66% shareholdings)
- the FX Reserves: McGraw Hill Financial Inc (0,05% shareholdings)

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.

When Norges Bank considers investing in a new instrument type a formal instrument approval process is undertaken. A due diligence analysis of the instrument is performed with the aim to identify major risk elements and key issues related to investments in the instrument, including substantial changes and challenges to investment operations, systems, documentation, reporting or routines. We assess the market, credit and counterparty risk of the instruments; what is the risk potential and is the risk possible to measure. Similarly, we assess whether performance can be measured in an acceptable fashion. In addition, a legal, compliance and operational due diligence of the instrument is performed. In this process, we use several sources of information, including credit rating agency analysis.

Our investment teams also conduct credit assessments of our fixed income investments, where we perform an internal fundamental credit analysis of the issuer and its industry. We use information from several sources, including the company files (company financials and outlook), credit rating agencies' methodologies and company ratings, and credit analysis conducted by investment banks or independent credit analyst institutions.

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.

Our investment team's overall use of credit ratings has decreased, as we have built up our own internal credit research team, which is responsible for covering all the issuers in our investment portfolio and hence performing the fundamental analysis "in-house". Even though we look at ratings and credit opinions from the agencies due to their importance in the market (pricing, investor types involved etc), they are not the most important element of our credit evaluations.

On another note, the Norwegian Ministry of Finance has issued an investment mandate to Norges Bank, which sets certain requirements for the investment activities of the Government Pension Fund Global. For the fixed income business, the mandate sets a benchmark index (certain Barclay's indices). The benchmark index is only for investment grade bonds in government and corporate bonds. The fund can deviate from the index to a certain degree. One investment restriction is a limit set of maximum 5 per cent for sub- investment grade bonds of the fixed income portfolio. A credit rating is required for investments in debt instruments. If a bond is not rated by one of the major credit rating agencies, an internal rating shall be set by our internal risk department. This set-up has been more or less the same prior to and after 2010.

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

Our risk team assesses the different CRAs methodology papers as part of the assessment of certain sectors and issuers. We also assess studies of actual defaults vs the levels derived from credit ratings. A CRA would need to demonstrate over time that issuers with a high rating (e.g. AAA/AA) default much less than issuers with a low rating (e.g. BBB/BB). These studies show that CRA has performed acceptable for corporates, not so for structured credits. For government bonds and covered bonds there are not enough data to robustly conclude. We have also assessed quantitative analysis comparing performance of probabilities of default derived from credit rating vs performance of probabilities of default derived from spread implied rating. We found the latter performed slightly better. We use both probabilities of default derived from credit ratings and from spread implied ratings in the risk monitoring of the fund's fixed income portfolio.

There are instances where we might disagree with a credit rating based on our internal fundamental research into a credit. There might also be instances where we disagree with a credit agency's methodology for a certain segment of the market or a specific credit (one example might be uplift for sovereign support/probability of sovereign support). We may also take the quality and experience of the individual analyst issuing the rating matters into consideration in our internal fundamental research.

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

We have two credit risk models for measurement of probability of default of the fixed income portfolio. One which is based on credit ratings (external and internal), and one that is derived from market spreads. We compare the two amongst other to identify discrepancies for further analysis of particular issuers or sectors. The latter model gives each issuer a spread implied letter rating in line with the S&P/Fitch ratings scale. For the credit rating model, we also set internal ratings for bonds that are not rated by the CRAs. We also set internal ratings of counterparties, when these are not rated by the CRAs. Overall, the number of issuers and counterparts used that do not have a credit rating from the CRAs are not very large. However, it is important to note that we do not only use credit ratings in the credit risk assessment and monitoring of issuers and counterparties. As noted, we set a spread implied rating for all issuers, and we do our own qualitative credit risk assessment. In our assessment, we use a number of different sources, including general market information about the issuer, different analysis from investment banks, credit research firms and analysis from CRAs.

Certain investment teams in Norges Bank use internal fundamental industry- and company analysis with tailor made financial models. Other teams do not have an internal ratings scale as the research they carry out is of a fundamental nature and does not easily let itself classify into a set framework of a ratings scale.

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

Generally, we find that the methodology papers for sectors and instruments are more detailed and in some cases more transparent now than before 2010. However, transparency can and should still increase. The more detailed information that is provided, the easier it is to understand the credit rating methodologies. However, the more complex rating models are not necessarily the better.

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

Generally, rating agencies have performed fairly good in the corporate and government sectors, but not for structured credits, as demonstrated in 2008 and onwards. We think it is too early to conclude if the quality of rating methodologies for structured credits has improved following 2010. Since Norges Bank does not have large investments in structured fixed income instruments, we have not considered this area in detail.

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

We also use our internal analysis of the company and sector to decide whether to invest or not.

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

We use unsolicitated credit ratings for government issuer ratings. Since most relevant information about countries are generally available (unless for some less developed countries or less open economies), we find the credit analysis undertaken on unsolicited basis as a useful supplement to the other credit risk analysis we do for assessing the credit quality of government bonds.
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Q11: Please explain whether, and if so how, your approaches to the issues raised in questions 4-10 above have changed since 2010.

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6.3 Independence and quality of credit ratings

4. One of the aims of the CRA Regulation is to increase the quality of credit ratings by seeking to reduce the conflicts of interest inherent where issuers pay for the rating of their financial instruments.[1]

5. The questions in this part aim to understand the different ways that CRAs can seek payment for the credit ratings issued and to assess the impact of the CRA Regulation on increasing the quality and independence of credit ratings.

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.

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

We pay for access to credit ratings analysis from the major credit ratings agencies for credit risk analysts and for employees on the investment side. We also pay to have the credit rating letter available to us in our systems.

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.

It is our understanding that most companies have had relationships with the various credit rating agencies for several years and have regular meetings with them to update on their business. This is normal course of business and it is positive that the relationship is well-established for familiarity with the business through the cycle.

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

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

We are of the opinion that improved transparency in methodology papers and rating rationale will increase the quality of the ratings.

Furthermore, ratings tend to be backward looking. Ratings may be improved by being more forward-looking and focusing more on expected sector dynamics. That said, this may imply less stable ratings and more ratings changes, something which not necessarily is considered as positive by companies or investors. In addition, we think that constantly questioning the validity of current sector ratings methodology, incorporating new developments and relevant factors are important and will improve the quality of the ratings.

6.4 Multiple credit ratings

6. The 2013 amendments to the CRA Regulation introduced a number of requirements on issuers and sponsors of structured finance instruments to obtain multiple credit ratings. These requirements are set out in Articles 8c and 8d of the CRA Regulation.

7. Article 8c of the CRA Regulation requires issuers to obtain at least two credit ratings for structured finance instruments. This obligation was introduced with the aims of restoring market confidence in complex financial instruments and reducing reliance on single credit ratings.[2]

8. Article 8d of the CRA Regulation aims to increase competition between CRAs by encouraging issuers to use smaller CRAs when they use multiple CRAs. Article 8d states that where issuers or related third parties intend to appoint at least two CRAs to rate an issuance or entity, they shall consider appointing at least one CRA with no more than 10% of the total market share where possible (hereinafter 'small CRA').

9. The question in this part aim to understand whether these provisions have achieved their objectives and the impact they have had on your business.

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

It is always useful with a second opinion and a cross reference.

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.

The market generally prefers debt with ratings to debt which is unrated, and similarly debt with several ratings to debt with only one rating. In short, the more ratings the better. The cost of obtaining a second rating will probably pay for itself in lower borrowing costs over time, so we assume that a company regularly issuing debt in the market would prefer to obtain a second rating without having a legal obligation to do so.

[2] 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.

Based on an assessment of the quality of the analysis over some time we may decide to use ratings from smaller CRAs. In our view, the ratings should be based on a structured approach to how a particular asset class is assessed, and calibrated to historical loss levels also taking into account relevant changes. The three largest CRAs cover most of the debt universe well, but we welcome smaller players with competitive niche services.

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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.

It requires a certain organisational size and relevant experience to produce credit ratings that are based on a structured methodological approach and that are calibrated to the default history of that asset class. In order to demonstrate solid credit rating capabilities, a credit rating agency needs to have been issuing credit ratings through at least one economic cycle. This approach does of course not create a lot of competition amongst CRAs and is an obstacle for new entrants. For the investor community it is important that there is competition between credit ratings agencies at the same time as quality is assured. We are in other words potentially prepared to use ratings from a CRA who has not previously rated a particular asset class, but we would first do a trial in order to access the quality of the services before we decide to subscribe or not

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 tranched, having both of the following characteristics:*

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

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

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

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

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6.6 Mandatory rotation

13. The 2013 amendments to the CRA Regulation introduced a mandatory rotation provision for CRAs issuing ratings on re-securitisations, which can be found in Article 6b of the CRA Regulation. Article 6b provides that CRAs may enter into ratings agreements for re-securitisations with a maximum length of four years, after which time they are prevented from rating new re-securitisations with underlying assets from the same originator for a period of four years.

14. The CRA Regulation notes that the implementation of a rotation mechanism should remove the incentive for a CRA to give favourable credit ratings to issuers on the basis of their existing relationships and could encourage other CRAs to start rating these instruments.[5]

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

16. Although this provision has only recently entered into force, the questions in this part are designed to help ESMA understand the impact of this provision and the extent to which it

[3] Article 4(1)(61) of Regulation No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation No 648/2012 , OJ L 176, 27.6.2013.
[4] OJ L 57, 6.1.2015, p. 2.
[5] See Recital 12 of Regulation 462/2013 of 21 May 2013.
[6] See Recital 15 of Regulation 462/2013 of 21 May 2013.

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.

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

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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;

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

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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.

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

6.7 Competition between credit rating agencies

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

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

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

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

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

In our opinion, the CRAs compete on:

- Coverage breadth
- Investor relationships
- Quality of ratings
- Training sessions/courses
- Technology (website access, online tools etc)

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.

It seems like there has been an increase in focus on providing investors with online tools to monitor rating changes and trends. In addition, it seems to be focus on offering courses to the users.

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.

It is our impression that the competition between the three large agencies is fierce. The main question however may not be how to stimulate competition between these three, but rather how to invite potential new entrants into this market.

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