Bundesverband der Deutschen Volksbanken und Raiffeisenbanken e. V.
Bundesverband deutscher Banken e. V.
Bundesverband Öffentlicher Banken Deutschlands e. V.
Deutscher Sparkassen- und Giroverband e. V.
Verband deutscher Pfandbriefbanken e. V.

Die Deutsche Kreditwirtschaft

Comments

Discussion Paper
The Use of Credit Ratings by Financial Intermediaries
Article 5(a) of the CRA Regulation

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR) for the cooperative banks, the Bundesverband deutscher Banken (BdB) for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB) for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV) for the Savings Banks Finance Group, and the Verband deutscher Pfandbriefbanken (vdp) for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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We thank ESAs for the opportunity to comment on the Discussion Paper on The Use of Credit Ratings by Financial Intermediaries. We would like to address several general issues relating to the Discussion Paper before providing more detailed comments on the specific questions asked.

There is wide-spread agreement that the importance of external ratings in the financial markets should be reduced. However, the deletion of any reference to external ratings in regulations and directives raises the question of their replacement since general agreement also exists in regard of the necessity for, or even a strengthening of, credit risk assessment.

Currently, the only known system capable of fully replacing external ratings is the Internal Ratings Based Approach (IRBA). Due to the availability of pool solutions in all three pillars of the German credit industry, the employment of internal rating approaches is in principle possible. Furthermore, institutes could obtain external data regarding the probability of default of data suppliers, for example, provided an internal assessment process is in place to prevent overreliance on these suppliers and their models. However, since smaller institutions are often overwhelmed by the procedural requirements (e.g. assessment and approval process requiring extensive documentation), we do not recommend abandoning the CRSA (involving the use of external ratings) in favour of the IRBA. In this context, smaller institutions should also not be placed at a disadvantage using central institutions of their respective financial group for short term refinancing (liquidity management) compared to those institutions which enter directly into open market operations with the European Central Bank.

Under the terms of the CRA Regulation, credit rating agencies are obliged to disclose information on conflicts of interest, methodologies and models. We see these requirements as one of the fundamental factors to ensure that users of external ratings do not overely on them. The disclosure obligations of Articles 8 and 10 of the CRA Regulation in respect of credit ratings, for example demanding regular publication of data on historical default rates in various product categories and information on the underlying assumptions of the ratings, are intended to assist users in making an informed assessment of the counterparty risks of externally rated issues and issuers.

The information published by credit rating agencies on the models they use has been improved to give investors and issuers a better understanding of both the rating process and the ratings themselves.
An overreliance on external ratings as presumed by the ESAs in the Discussion Paper is no longer possible, particularly for regulated institutions, as there are now several requirements (e.g. in Germany the Minimum Requirements for the Risk Management of Credit Institutions (MaRisk), IRBA process requirements, economic capital, disclosure rules) that call for an internal risk analysis.

With reference to the MaRisk, which contain the requirements for the implementation of the second pillar, external ratings are allowed to use by credit institutions only as an element of internal risk assessment, which is usually complemented and validated by additional parameters.

However, it should be noted that the information which rating agencies possess because of detailed and continuous analyses of their clients usually go beyond the sources of information available to the credit institutions to be rated. For a proper risk assessment, this information is therefore important, in particular for small and medium-sized banks. For this reason, discarding external ratings altogether as an element of risk assessment is not in the credit institutions' interest; nor will this lead to the improvement of risk assessment intended by the regulator. We therefore argue that external ratings should continue to be used in future as one of several input parameters for internal risk assessment.

Q9. To what extent do your business lines use external ratings? Please specify by activity.

- Lending business:
    - In Germany in SME segments only an extremely small percentage of German enterprises is externally rated.
    - External ratings by major rating agencies (S&P, Moody's, Fitch) involve significant financial expenditure; the benefit provided for SMEs is questionable (hence, "credit ratings loophole"); smaller agencies (Creditreform, Rating Services) have entered the ratings market and are included as rating factors in a few rating systems or, if ratings are significantly downgraded, are integrated as warning signals into the classification process.
    - In the case of corporate customers with external ratings, credit institutions take this information into consideration in their rating and lending processes. In our opinion, the primary role of this information for credit institutions is to verify the plausibility of their own assessment; however, external ratings are not considered to be traditional rating factors in many banks. For this reason, they do not play a major role in lending decisions. Internal rating or scoring are much more important in this respect.

- Banks' own investment business
    - External ratings are taken into consideration in the banks' own investment decisions. Some credit institutions have introduced investment guidelines, limits and, in some cases, limit systems, according to which proprietary transactions are permitted only up to certain rating grades, and the investment amounts per rating grade are also limited. Such robust and simple instruments should therefore continue to be admissible.
    - This information is of great benefit in particular for smaller credit institutions because of their limited resources and know-how for conducting their own analyses.

  - Using the existing methods and instruments, credit risk measurement of proprietary investments would be inadequate without the use of external ratings.

- Customers' security deposits business
  - Each financial instrument is extensively reviewed, based on different quality and suitability criteria, depending on the class, the financial instrument and the service involved. The credit worthiness of a financial instrument's issuer is only one of these criteria. External ratings are mainly used for this purpose. The plausibility of these external credit ratings is verified by means of other assessment criteria (e.g. research reports by financial analysts, financial press, etc.) in order to rule out automatisms. Nevertheless, we would like to draw attention to the fact that performing comprehensive credit assessments on specific securities would involve inordinate expenses, in particular for smaller credit institutions. In addition, external ratings probably also provide the more objective and most plausible credit risk assessment for investors, as rightly pointed out in the Discussion Paper (see p. 26).
  - We are of the opinion that "investors" which should be encouraged by credit institutions and investment firms to do their own due diligence mentioned in Recital 9 can only be "regulated investors" in the sense of Recital 8.

In our view, the influence of external ratings should be limited when it plays the main role in a bank's assessment or decision-making process and thus leads to herd behaviour. However, the use of external ratings should not be flatly denounced because such ratings may serve as indicators and support internal assessments, or they may be used to identify errors in internal models.

External ratings are used in particular by small and medium-sized credit institutions with a regional focus in connection with (ancillary) investment services, including proprietary trading. Securities held for proprietary trading to diversify risks are issued by governments, banks and large industrial companies which usually have at least one rating. Abstaining from the use of references to ratings would constitute a radical departure from current practice.

Q9 i) What are the main reasons to use external ratings in contractual agreements?

Contracts usually do not contain any reference to ratings. In exceptional cases, they are included as triggers for rights to demand additional security or to terminate a contract. To an even lesser extent, they trigger restrictions on the distribution of dividends to equity investors or higher interest payments.

Q9 ii) Are there elements in your contractual agreements that limit or mitigate the risk of sole and mechanistic reliance on external ratings?

We cannot rule out that there are isolated contracts with clauses which are triggered solely by an external rating. However, these would be found in only very rare cases.

Q10. What in your view are the main advantages or disadvantages of using external ratings?

- Advantages:
    - Simplicity (easy to obtain and to use)
    - Easy to track any changes
    - neutral assessment by independent agencies
    - High-quality third-party perspective
    - Objective variable for investment advice
- Disadvantages
    - Dependence on rating agencies
    - Method used to determine rating not transparent and often difficult to understand
    - Herd behaviour (“cliffs”)

Q11. Do you conduct any analysis of the underlying methodologies of the ratings you rely on? If so what in your view are the strengths and weaknesses of the methodology?

We regularly validate the ratings used internally, both centrally (pool) and locally.

Q12. Can you provide examples of past experience where external credit ratings provided an inaccurate credit worthiness assessment? If so, what actions were taken in response to mitigate similar occurrences?

No comments.

Q13. What internal risk analyses do you currently employ? What business lines are these employed in? To what extent do they utilise external ratings? What are the main advantages of these internal analyses?

The internal risk analyses applied include scoring and rating methods. These credit worthiness assessments are based on a large number of factors (balance sheet ratios and qualitative factors as a function of an enterprise’s legal status, size and sector).

Q14. Please specify what alternative references or benchmarks your internal risk analyses make use of.

Primarily, backtesting actual defaults versus estimated defaults.

Q15. Are these alternative measures point-in-time or through-the-cycle compared with external ratings?

The actual defaults tested are often mixed system between TTC and PIT-systems and also PIT-systems.

Q16. In what areas is reducing reliance on external ratings necessary or at least desirable?

See above (In our view, the influence of external ratings should be limited when it plays the main role in a bank's assessment or decision-making process and thus leads to herd behaviour.)

As mentioned earlier, external ratings play a less important role for credit institutions in their lending business because they are less widespread in Germany and are expensive for SMEs. It is therefore rare for clients of member institutions to have external ratings. External ratings are used by banks in their own investment business and in their customers' security deposits business. However, the risk of incorrect ratings is taken into account by means of internal limit systems. If reliance on external ratings is to be reduced, the credit institutions must be given an easy-to-use alternative.

Q17. What in your view are the main challenges preventing you from reducing reliance on external ratings in your business?

Ignoring the ratings of large clients developed by external agencies on a broader information base would be tantamount to deliberately excluding available information. This is not admissible for IRBA institutions.

Q18. How could the reduction of contractual references to credit ratings influence, in your opinion, the transmission of systemic risk?

In the cases you cited (transmission of systemic risks), a ban on references to external ratings cannot be effective because the information is available in the market, and in such cases, this information will have its effect, irrespective of whether it is functionally incorporated into the rating.

Q19. Are there any additional points you would like to highlight with regards to contractual reliance on external ratings?

No comments.