



European Securities and
Markets Authority

ESMA's supervision of credit rating agencies, trade repositories and monitoring of third country central counterparties

2017 Annual Report and 2018 Work Programme





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List of Acronyms

BTRL	Bloomberg Trade Repository Limited
CEREP	CEntral REPOSITORY of credit rating data reported by CRAs to ESMA according to Commission Delegated Regulation 448/2012 of 21 March 2012 with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority
CFTC	U.S. Commodity Futures Trading Commission
CME TR	CME Trade Repository Ltd.
CRA	Credit Rating Agency
CRA Regulation	Regulation (EC) No 1060/2009 on credit rating agencies as amended by Regulation (EU) 513/2011 and Regulation (EU) 462/2013
Delegated Regulation on Fees	Delegated Regulation 2015/1 on the reporting of fees charged by credit rating agencies
DDRL	DTCC Derivatives Repository Ltd.
DQAP	Data Quality Action Plan
ECB	European Central Bank
EMIR	Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories
Endorsement Guidelines	Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation, published on 17 November 2017 (ref. ESMA33-9-205)
ERM	Enterprise Risk Management
ESMA	European Securities and Markets Authority



ESMA Regulation	Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority)
ESRB	European Systemic Risk Board
ETD	Exchange Traded Derivative
EU	European Union
Fitch	Credit rating agencies within Fitch Group
Guidelines on Portability	Guidelines on transfer of data between trade repositories (ref. ESMA70-151-552)
ICE TVEL	ICE Trade Vault Europe Ltd.
IIO	Independent Investigating Officer
INED	Independent Non-Executive Director
IOSCO	International Organization of Securities Commissions
IT	Information Technology
ITS	Implementing Technical Standards
KDPW	Krajowy Depozyt Papierów Wartościowych S.A.
MIS	Moody's Investors Service
MoU	Memorandum of Understanding
Moody's	Credit rating agencies within Moody's Corporation, including Moody's Germany and Moody's UK
Moody's Germany	Moody's Deutschland GmbH
Moody's UK	Moody's Investors Service Limited
NATR	NEX Abide Trade Repository Limited AB
NCA	National Competent Authority
OTC	Over-the-counter



Periodic Information Guidelines	Guidelines on periodic information to be submitted to ESMA by Credit Rating Agencies Guidelines (ref. ESMA/2015/609)
Q&A	Questions and answers
RADAR	ESMA's credit RATings DAta Reporting tool
REGIS-TR	REGIS-TR S.A.
RTS	Regulatory Technical Standard
Securitisation Regulation	Regulation (EU) No 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.
SFTR	Securities Financing Transactions Regulation
SFT TR	Securities Financing Transactions Trade Repository
S&P	Credit rating agencies within S&P Global Inc.
TC-CCP	Third-Country (non-European) Central Counterparty
TR	Trade Repository
TRACE	ESMA's Trade Repository Data Reporting tool
UK	United Kingdom
UnaVista	UnaVista Limited
Validation Guidelines	Guidelines on the validation and review of Credit Rating Agencies' methodologies (ref. ESMA/2016/1575)

Executive Summary

The European Securities and Markets Authority is publishing its annual report and work programme to highlight its direct supervisory activities during 2017 regarding CRAs and TRs and outline its main priorities in these areas for 2018. In addition, this document outlines ESMA's activities regarding the monitoring of non-European central counterparties (TC-CCPs) in 2017 and going forward into 2018.

Main activities of 2017 and priorities for 2018

1. ESMA's supervisory activities and achievements for 2017 are:

TR and CRA supervision

- Supervision of eight registered TRs, 26 registered CRAs and four certified CRAs;
- Thematic review following the publication of the Validation Guidelines and the publication of the Endorsement Guidelines for CRAs, Guidelines on Portability for TRs and various Q&As for CRAs and TRs;
- Supervisory work to improve the quality of data reported by TRs through the Data Quality Action Plan, engagement with data users and monitoring the implementation of new validation requirements;
- Investigations into the system development lifecycle of a TR and access to TR data by NCAs;
- Investigations into changes of analytical approach, rigorousness of CRA methodologies, interactions between CRAs and issuers and the issuance process of structured finance ratings;
- Ongoing work into the contingency plans set up by CRAs and TRs in light of Brexit;
- Thematic review of fees charged by CRAs and TRs and publication of report on the outcome of this review and the way forward (published on 11 January 2018); and
- Imposition of a EUR 1.24 million fine with respect to Moody's UK and Moody's Germany for failure to comply with requirements of the CRA Regulation concerning the presentation of credit ratings and the disclosure of methodologies.

TC-CCPs

- Recognition of 10 TC-CCPs from a variety of jurisdictions following the December 2016 equivalence decisions from the Commission;
- Monitoring of the activities and services provided by recognised TC-CCPs in the EU;

- Data gathering on interlinkages and exposures of EU entities with those TC-CCPs; and
 - Data analysis of the potential risks TC-CCPs might bring to the EU.
2. For 2018, ESMA has conducted a supervisory risk assessment regarding CRAs and TRs in the EU, which identified the following supervisory priorities:
- TR supervision
- Data quality with a particular focus on the Data Quality Action Plan;
 - Information technology and internal control, including TRs' system development life cycle and internal control systems; and
 - Strategy and governance, focusing on TRs' governance structures and management quality.
- CRA supervision
- Quality of the credit rating process, including CRAs' validation practices;
 - IT and internal controls with a particular focus on information and cyber security; and
 - Strategy and governance, focusing on management quality and material changes to CRAs' governance structures.
3. In addition, there are a number of areas where there are common issues across TRs and CRAs on which ESMA will perform further work including Brexit, fees charged by CRAs and TRs, the internal control framework, cloud computing and guidelines for periodic information.
4. For TC-CCPs, ESMA has identified the following priorities for 2018:
- Assessment of the 15 pending applications for recognition as TC-CCPs;
 - Monitor the potential risks TC-CCPs might introduce in the EU;
 - Monitoring the impacts of Brexit on the third country CCP regime; and
 - Anticipation and readiness with respect to the potential changes in the scope of ESMA supervision of TC-CCPs following the current review of the applicable regulations.

TR supervision

The supervision of TRs by ESMA started in 2013 with their registration. ESMA had registered six TRs by November 2013, which triggered the trade reporting obligations to TRs set out in EMIR. During 2017, ESMA registered two additional TRs, Bloomberg Trade Repository Limited and NEX Abide Trade Repository AB, which brings the total number of TRs registered in the EU to eight. ESMA's supervisory work requires close cooperation with

National Competent Authorities (NCAs) in the EU Member States, as they are responsible for supervising the counterparties reporting to TRs. NCAs are amongst the key users of TR data.

Trade reporting to TRs began in February 2014. By the end of 2017, approximately 65 billion reports had been received by TRs, with an average of around 400 million trade reports submitted per week. During 2017, the TRs faced a number of important regulatory changes. ESMA published the Guidelines on Portability, which clarified how clients can migrate from one TR to another. The entry into force of the SFTR, MiFIR and the introduction of similar legal frameworks for trade reporting in non-EU jurisdictions is expected to provide opportunities for existing TRs, their group entities and new players.

SFTR implementing measures will probably enter into force in 2018 and market participants will be required to start reporting securities financing transactions to registered SFT TRs 12 months after entry into force. Several existing TRs are expected to apply for registration as SFT TRs. The entry into force of the SFTR, including the assessment of applications for registration will be a key priority for ESMA in 2018.

In line with the priorities set out in the TR supervision work programme for 2017, ESMA focused its attention on data quality, data access, technology trends and internal control, and financial strategy and governance of TRs in 2017.

During 2017, ESMA has increased its engagement with NCAs and data users to improve data quality. An important part of this work focused on the Data Quality Action Plan, which aims to improve the quality and usability of data that is reported to and by the TRs. In addition, ESMA reviewed the completeness and accuracy reported through the TRACE platform. ESMA also focused on data validation as the introduction of new reporting requirements in 2017 led to a temporary uptick in rejections, which then reduced once TRs and counterparties adapted to the new reporting requirements.

ESMA saw improvements in inter-TR reconciliation due to its continued work on the topic by monitoring the correct implementation of pending corrective actions by TRs and by further analysing the supervisory and statistical information collected around the process. Data access by NCAs and public authorities was addressed in a dedicated investigation regarding on boarding, access set-up and management.

ESMA has continued to engage with TRs regarding strategy, governance and operational matters. Throughout the year, ESMA has performed a number of on-site visits to discuss with key staff, senior management and the Boards of TRs strategic and operational matters. A recurring area of concern for ESMA is the level of resources including staff and technological solutions of TRs. ESMA has stressed this issue in its interactions with TRs.

Over the course of 2017, ESMA monitored the internal control activities performed by TRs within the context of their system development lifecycle controls and practices that have a direct effect on the completeness and accuracy of TR data. Through its interactions with TRs, ESMA has noticed issues regarding the resourcing and empowerment of TRs' compliance functions. In order to clarify its expectations in this area, ESMA has sent a letter to TRs outlining the key principles for the compliance function within TRs.

Technology plays a key role within TRs and robustness and reliability of their IT systems is an important driver of their ability to perform their duties under EMIR. Therefore, ESMA has dedicated significant resources to this area in 2017 through interactions with key staff, an in-depth investigation and active monitoring of incidents and material changes.

For 2018, in addition to the common priorities for TRs and CRAs, the risk assessment for TRs performed over the course of 2017 has identified data quality, IT and internal controls, strategy and governance as key priority areas. More specifically, within these priorities, ESMA will focus on the Data Quality Action Plan, the system development life cycle, the governance structures of TRs and their internal control system.

CRA supervision

ESMA is currently supervising 26 registered and four certified CRAs. Over the course of 2017, ESMA registered one new CRA and one registration was withdrawn, keeping the number of CRAs supervised by ESMA unchanged. ESMA expects to receive various new applications for registration during the coming years.

Industry dynamics remained largely the same over the course of 2017, although a few of the smaller CRAs have seen a slight increase in their market share.¹ The main priority for ESMA in 2017 related to the improvement of the quality of the rating process. ESMA used a number of supervisory tools in this area, including dedicated investigations, remedial action plans and thematic work streams. ESMA also engaged with CRAs regarding disclosure practices and timing of the publication of sovereign ratings to ensure a level playing field in these areas.

In addition, ESMA conducted dedicated investigations into how a CRA implemented changes in the analytical approach and the rating process for the issuance of structured finance ratings. ESMA also took enforcement action against Moody's UK and Moody's Germany. The ESMA Board of Supervisors found that these entities had committed infringements of the CRA Regulation concerning the presentation of ratings and disclosure of methodologies and imposed various fines totalling EUR 1.24 million.

¹ [https://www.esma.europa.eu/sites/default/files/library/esma33-5-209 - cra market share calculation 2017.pdf](https://www.esma.europa.eu/sites/default/files/library/esma33-5-209_-_cra_market_share_calculation_2017.pdf)

An important part of ESMA's supervision activities relates to ongoing supervision, which includes reviewing periodic information, assessing information received from whistle-blowers and market participants, implementation of remedial action plans following investigations and a cycle of engagement with key staff of CRAs. As part of its monitoring activities, ESMA also conducted a series of one-day meetings with smaller CRAs to complement its risk assessment. ESMA also intensified its cooperation with international CRA regulators.

An important policy work stream in 2017 was the publication of ESMA's Endorsement Guidelines² in which ESMA clarified its supervisory powers, the obligations of endorsing CRAs and objective reasons for endorsing credit ratings elaborated outside the EU. In 2017, ESMA also undertook a thematic review following the publication of the Validation Guidelines, which clarified ESMA's expectations on the use of quantitative and qualitative measures in validating methodologies. ESMA assessed the implementation of the guidelines through a questionnaire sent to all registered CRAs.

IT and internal controls have been important topics for ESMA in 2017, driven by the high levels of risk identified in these areas in the 2016 risk assessment. In order to better assess the effectiveness of internal controls and the IT and information security risk, ESMA met with key staff, assessed periodic information and incidents reported by CRAs and monitored the implementation of remedial action plans. ESMA also revisited the highest risk areas that were identified during the 2015 IT risk assessment where ESMA observed improvements in a number of CRAs.

As part of its supervisory activities regarding the strategy and governance of CRAs, ESMA monitored important reorganisations and had regular interactions with senior management and independent board members of CRAs to understand the strategic direction and governance of CRAs. Important topics for discussion in this respect were the compliance culture of CRAs and the tone at the top.

For 2018, the risk assessment for CRAs identified the quality of the rating process as the main priority area. Furthermore, ESMA will focus on IT and internal controls and strategy and governance of CRAs. Within these areas, ESMA will focus on addressing issues that affect the quality of the rating process, validation practices, cyber security and internal controls.

² https://www.esma.europa.eu/sites/default/files/library/esma33-9-205_final_report_on_the_application_of_the_cra_endorsement_regime_1.pdf

Areas of common supervisory focus for CRAs and TRs

As set out in the 2017 work programme, ESMA has developed an improved risk assessment process and framework for TRs and CRAs. This allows ESMA to better identify and evaluate supervisory risks. The tool also facilitates decision-making and the allocation of supervisory efforts in line with ESMA's risk-based framework.

ESMA has also worked on a number of common areas of focus for CRAs and TRs, including internal controls, cloud computing, Brexit, fees and ancillary services and the development of supervisory tools. In the beginning of 2018, ESMA published a thematic report on its findings regarding the application by CRAs and TRs of key provisions regarding fees charged to clients.

Considering several registered CRAs and TRs are currently based in the UK, Brexit was a key supervisory priority in 2017. Therefore, ESMA requested that TRs and CRAs put in place contingency plans in case the UK leaves the EU with no agreement in place. In this respect, ESMA also published an opinion setting out general principles aimed at fostering consistency in authorisation, supervision and enforcement related to the relocation of entities, activities and functions from the United Kingdom.³ ESMA's objective in this respect is to ensure that in case a CRA or TR intends to continue its operations in the EU, the set up of TRs and CRAs post-Brexit in the EU is as strong as pre-Brexit, is proportionate to the activities performed in the EU27 and complies with all requirements of EMIR and the CRA Regulation. If a CRA or TR does not intend to maintain its EU registration post-Brexit, the contingency plan needs to include a proper withdrawal process.

For 2018, ESMA has identified a number of common priority areas for CRAs and TRs. ESMA will continue its joint work on Brexit and follow-up on the issues identified in the thematic work on fees charged by CRAs and TRs. In addition, ESMA will finalise its expectations regarding the implementation of an effective internal control system and assess the compliance risks with respect to cloud computing. ESMA will also work on publishing new guidelines on periodic information for CRAs and introduce such guidelines for TRs and further developing its supervisory tools.

TC-CCP recognition

Regarding TC-CCPs operating in the EU, ESMA recognises TC-CCPs initially and subsequently each time a TC-CCP extends its range of activities and services ESMA reviews its recognition.

³ https://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf



ESMA also assesses whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

In 2017, ESMA performed the recognition process for 10 TC-CCPs following the publication of new corresponding equivalence decisions by the Commission in December 2016.

In 2018, ESMA will pursue the recognition process of the remaining TC-CCPs applicants for which an equivalence decision is adopted and of recognised TC-CCPs extending their activity together with the assessment of the related clearing obligation for the relevant OTC derivatives. ESMA will negotiate and sign the corresponding MoUs with the relevant home country supervisor. It will monitor that recognised TC-CCPs comply with the EMIR criteria and equivalence conditions, if applicable, on an ongoing basis.



Introduction

1. ESMA is one of the three European Supervisory Authorities, which, together with the ESRB and NCAs, make up the European System of Financial Supervision. The European System of Financial Supervision was established in the wake of the global financial crisis with the aim of improving the quality and consistency of supervision, strengthening the oversight of cross-border groups and establishing a single rulebook for all financial market participants within the EU.
2. ESMA's mission is to enhance investor protection and promote stable and orderly financial markets. In 2011, ESMA was designated as the single supervisor of CRAs within the EU in accordance with the provisions of CRA Regulation. The following year, ESMA was given direct responsibility for the registration and the supervision of TRs within the EU.
3. In accordance with ESMA's strategic orientation for 2016-2020,⁴ ESMA is continuing to strengthen its role as a direct supervisor. The Supervision Department follows a risk-based approach for TR and CRA supervision and focuses its action in those areas where its resources may have the greatest impact.
4. In 2018, ESMA is expected to implement its new direct supervisory mandate under SFTR, which aims to increase the transparency of securities financing transactions. These transactions include repurchase arrangements, securities lending, sell/buy-back transactions, and margin lending. The SFTR will require both financial and non-financial market participants to report details of securities financing transactions to a TR registered or recognised by ESMA.
5. In addition, in January 2019, the Securitisation Regulation will become applicable. This Regulation sets out a framework for securitisation repositories to collect relevant disclosures on securitisations. ESMA anticipates preparatory work in 2018 for the assessment of applications for registration of securitisation repositories.
6. This report provides an overview of the activities undertaken by ESMA in 2017 pursuant to the CRA Regulation and EMIR and sets out ESMA's supervision work programme for 2018.

⁴ ESMA/2015/935, ESMA Strategic Orientation 2016-2020, 15 June 2015, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935_esma_strategic_orientation_2016-2020.pdf.

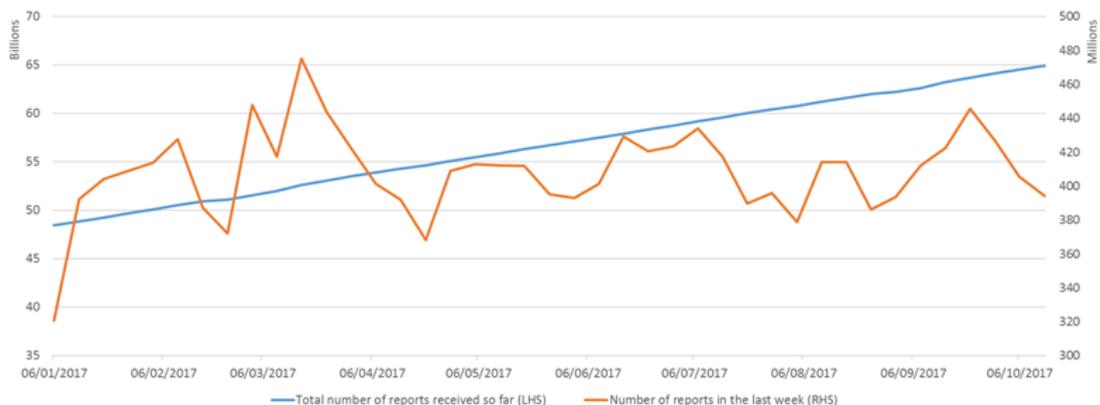
A. Supervision of Trade Repositories and Credit Rating Agencies

1 Supervision of Trade Repositories

1.1 Industry state of play

- In 2017, ESMA assessed the application of two new entities who have applied for registration in the EU. These applications (for BTRL and NATR) were both approved. Overall, the six existing TRs (excluding BTRL and NATR) have maintained a similar market share to last year. Third party intermediaries also played an important role, by reporting on behalf of an increasing number of counterparties to TRs.

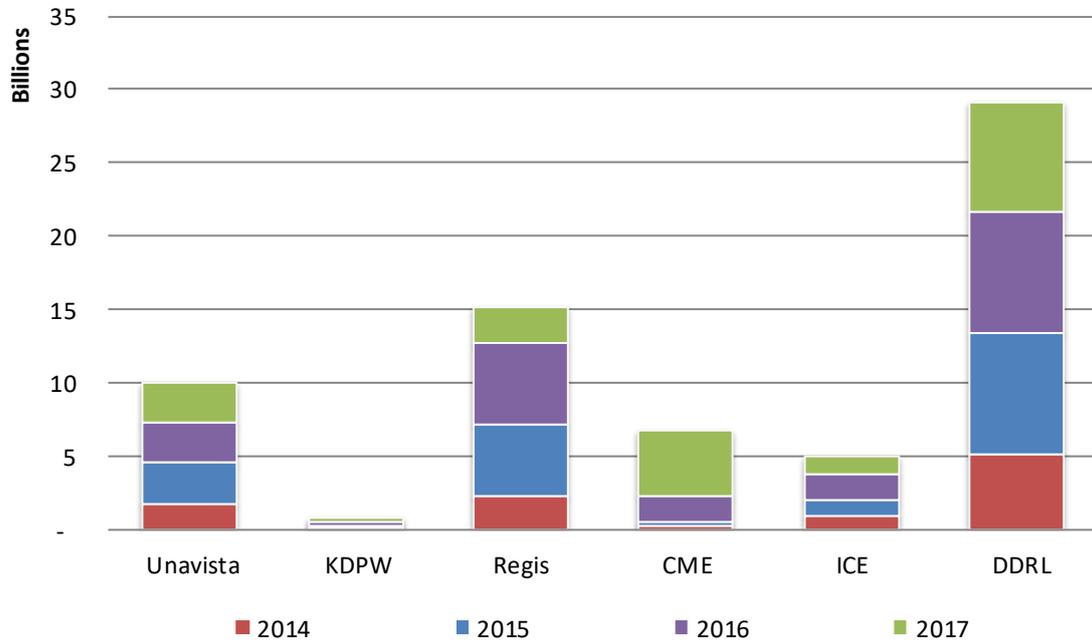
Figure 1 - Total number of reports received since reporting began in 2014



Source: ESMA calculations based on weekly reports from all TRs

- By the end of 2017, the eight TRs operating in the EU had collected nearly 65 billion reports in total. The reports do not only include new trades but also their modifications and other lifecycle events. During the course of this year, the level of reporting activity has stabilised at an average of around 400 million submissions per week, as illustrated in Figure 1 above.
- The Guidelines on Portability were published in August 2017 (see section 1.2.3 regarding the transfer of data between TRs). These guidelines clarified how clients can migrate from one TR to another, and they are expected to trigger more movement of TR clients. In addition, the entry into force of the SFTR is expected to provide opportunities for existing TRs and new players.

Figure 2 - Number of reports received as of the end of November 2017



Source: ESMA calculations based on weekly reports from all TRs

10. On 1 April 2017, the Swiss regulator FINMA recognised REGIS-TR S.A. as a foreign trade repository in accordance with the Financial Markets Infrastructure Act (FMIA) for the receipt of reports about derivatives transactions from persons subject to reporting requirements.
11. Other regulatory changes such as preparation for SFTR (and MiFIR for the group entities of some TRs) will also affect TRs and their relevant stakeholders as reporting and processing technologies will have to be adjusted to the new standards.
12. Counterparties have additional reporting requirements for MiFIR that may further affect reporting. The changes necessary for these extra reporting requirements by TRs and counterparties are a significant risk for 2018, as counterparties may divert existing resources to implement and prepare for additional reporting requirements rather than add resources to meet current requirements.
13. Against these changes, it is important to stress that while the effect of political, market and regulatory factors on TRs is difficult to predict, TRs need to ensure compliance with EMIR under all circumstances. ESMA's role is to monitor whether TRs meet their obligations under EMIR and to take supervisory actions where necessary. The main observations, actions and achievements from ESMA's TR supervision in 2017 are reported further below.

1.2 Supervision

14. In line with the priorities set out in the TR supervision work programme for 2017, ESMA focused its attention on data quality, data access, technology trends and internal control, and financial strategy and governance of TRs.
15. Where necessary, due to ad hoc events or information received, and in line with its risk-based approach, ESMA has also reprioritised issues to focus on the highest risk areas. Examples of ad hoc events that resulted in a reprioritisation are reported incidents or material changes that required immediate attention as they had a direct impact on availability and access to data. These events include issues with reporting after the implementation of the new RTS, the registration of new TRs, and the migration of a large counterparty to a new TR.

1.2.1 First new EU-registered TRs since 2013

16. ESMA registered the first new TRs since the end of 2013. BTRL was registered and supervised by ESMA for EMIR reporting, with effect from 7 June 2017. BTRL is based in the UK and covers all derivative asset classes (i.e. commodities, credit, foreign exchange, equities, and interest rates).
17. NATR was registered and supervised by ESMA for EMIR reporting, with effect from 24 November 2017. NATR is based in Sweden and covers all derivative asset classes. The registration of these two TRs means that they can now be used by counterparties to fulfil their trade reporting obligations under EMIR.
18. BTRL and NATR joined the six existing TRs in receiving, processing and providing access to derivatives trade reports. Currently, 46 regulatory authorities including NCAs and central banks have access to at least one EU TR and are able to view and analyse the data in line with their mandates.

1.2.2 Data quality and data access

19. TRs play an integral role in enhancing the transparency of derivative markets and reducing risks to financial stability by providing data to regulators and researchers. Poor quality data limit the capabilities of data users to identify and respond to systemic counterparty and financial system risk. Data users rely on TRs to provide access to authorities and to ensure the quality of the data complies with the regulatory standards.

Data quality action plan

20. TR data quality is affected by both counterparties and TRs. Counterparties submit data to TRs, which TRs then validate and submit to regulators. Given the dual supervisory framework of EMIR, where ESMA supervises TRs and NCAs supervise the entities who



report to TRs, a joint effort is necessary to ensure high quality data. Against this background, in September 2014, ESMA and NCAs jointly launched the 'Data Quality Action Plan' (DQAP) which aims to improve the quality and usability of data that is reported to and by the TRs. The following paragraphs emphasise the areas that were focussed on during 2017 to improve data quality.

21. In 2017, ESMA continued to monitor the data received from TRs via the data quality dashboard developed in previous years. The dashboard is updated on a monthly basis and summarises statistics that indicate the level of data quality across different dimensions. This overview allows for the identification of data quality trends and persistent issues that would not otherwise have been discovered.
22. In 2016, ESMA developed an IT system (TRACE) which allows NCAs to have a single point of access to the data stored by TRs under the EMIR legislation. This project should assist regulatory authorities in using TR data more actively. In 2017, ESMA assessed the completeness and accuracy of the information reported through TRACE. More specifically, this project included a comprehensive comparison of the trades made available to ESMA through TRACE with the trades that have been delivered through the pre-existing format. The results of this project were communicated to NCAs to provide an overview of the comparison between TRACE data and the data reported by the TRs via the existing channels. ESMA communicated these differences to TRs, and several fixes have subsequently been implemented.

Engagement with Data Users

23. ESMA initiated a data quality log to further increase cooperation with NCAs and users of EMIR data regarding data quality issues in 2017, with more users of EMIR data expected to be included in the process during 2018. The issues reported from other users of EMIR data outside of the NCAs primarily came from the ECB and ESRB.
24. The EMIR data quality log prevents the replication of effort for several NCAs and other users of EMIR data that may pursue similar issues with TRs in parallel, while also providing clarity to the data users as to why certain issues are getting priority. This process involves collecting information on data quality issues from data users through a standardised template. These issues are then assessed and prioritised by ESMA. The list of prioritised issues is subsequently communicated to NCAs first, followed by other data users, to allow for increased transparency of all outstanding issues. ESMA also receives comments from NCAs on an ongoing basis regarding counterparty reporting to TRs.

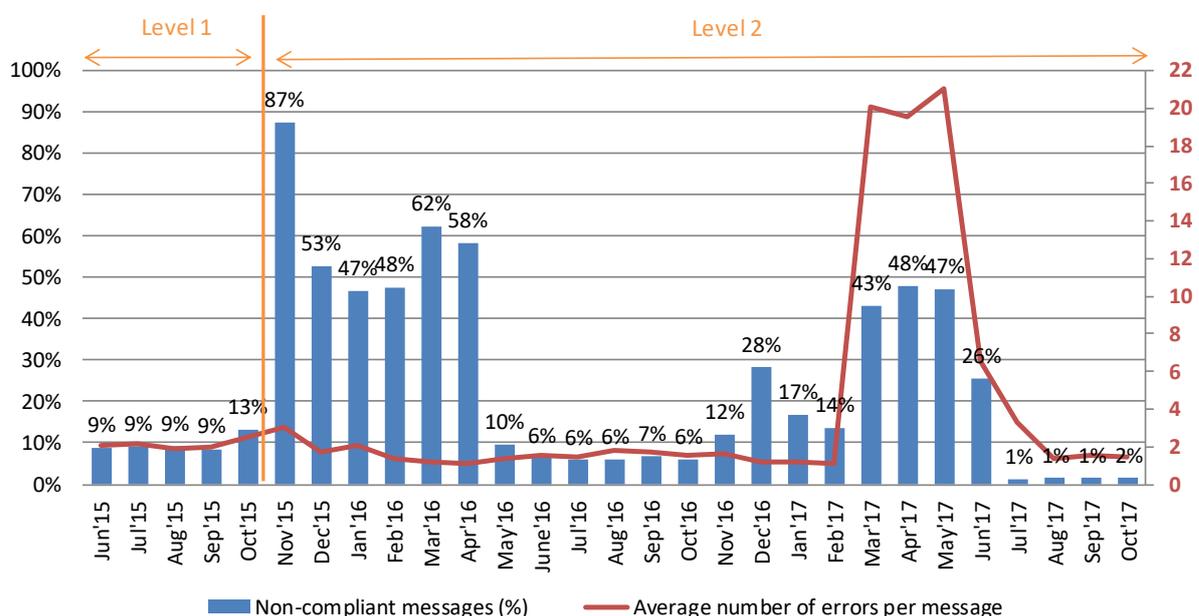
Data Validation

25. ESMA regularly performs a re-validation of the data made available by TRs since the introduction of the validation rules. The objective is to assess whether the validation requirements have been implemented correctly by the TRs. ESMA randomly selects one

day each month for which the complete daily activity reports across all TRs are re-validated.

26. The revised regulatory and implementing technical standards on reporting under Article 9 of EMIR (RTS/ITS) came into effect on 1 November 2017. The effect on data quality is in line with expectations, with an observed increase in rejection rates in the weeks after the implementation of the new RTS that have subsequently decreased.
27. It should be noted that the data made available to ESMA during the period immediately after the introduction of Level 2 validation in November 2015 was largely non-compliant with the validation requirements. There has also been an increase in non-compliant messages following the implementation of the recent revised RTS/ITS. Based on this trend, there could be an increase in noncompliant messages for the coming months. ESMA will continue to identify and monitor these issues via the re-validations.
28. When necessary, ESMA has followed up with the TRs to make sure the necessary fixes are implemented. The graph below presents the results of the re-validation performed from June 2015 to October 2017.

Figure 3 – Rejection rates after re-validation across all TRs



Source: ESMA calculations based on daily activity reports from all TRs

29. By informing the TRs that fields contained erroneous values and by stressing the importance of data quality, ESMA's supervision activities have led to improvements in overall data quality. There was a significant increase in non-compliant messages in March 2017 as a TR altered the format of the reports to regulators to fix outstanding issues. This



subsequently led to sustained improvement in data quality in the months prior to the new RTS/ITS.

30. The quality of data reported to TRs also defines the usability and accuracy of the aggregate data that is publicly made available by TRs on their websites on a weekly basis. Although the format of aggregate reports is standardised across TRs, the content still depends a lot on the contribution of all parties involved in the reporting process (namely reporting entities and TRs). When adopted by the European Commission, the recently published draft technical standards on data to be made publicly available by TRs under Article 81 of EMIR will further standardise these data across TRs.

Inter-TR Reconciliation

31. Another component of the DQAP is further improving the results of inter-TR reconciliation. The EU reporting regime requires both counterparties to a trade to report the transaction. The TRs are obliged to reconcile the trades between themselves where counterparties report to different TRs. However, in practice this process has not been that straightforward mainly for data quality reasons.
32. ESMA continued the work on reconciliation by monitoring the correct implementation of the pending corrective actions by TRs and by further analysing the supervisory and statistical information collected around the Inter-TR reconciliation process. Measures implemented up to now have demonstrated improvements.
33. For example, the average pairing rates in November 2017 have risen to 87% (average across TRs) up from 55% from November 2016. To further strengthen this trend and keep the momentum, ESMA has revised, and is planning to implement, a new reconciliation statistics report to better monitor and assess TRs' performance individually and as a group as well.
34. ESMA continued to closely engage with NCAs and exchange data to identify counterparties where reporting causes large amounts of breaks in the reconciliation process. ESMA plans to further intensify its engagement with the NCAs as part of the NCA cooperation process related to data quality.

Data Access

35. By the end of 2017, the TRs reported on behalf of approximately 5,900 direct clients. This number includes clients that as third parties report on behalf of other counterparties and entities. These counterparties and entities have only the right to view data that has been reported on their behalf. In total, there are around 580,000 counterparties whose trades are reported to TRs.
36. Some NCAs are not yet using their right to access and use TR data. ESMA has monitored the progress on access to TRs by competent authorities throughout 2017. As of



December 2017, 46 regulatory authorities including NCAs and central banks had access to at least one TR. In order to further facilitate competent authorities' access to TR data, ESMA has developed an IT system (TRACE) which allows NCAs to have a single point of access to the data stored by TRs under the EMIR legislation.

37. Data access was addressed in a dedicated supervisory investigation during 2017. ESMA examined the process followed by the TR for regulatory on-boarding, access set-up and management. This investigation covered the technical design and implementation of data filtering and regulatory data access, related system operations including regulatory reporting incidents, and the governance arrangements and internal control mechanisms put in place by the TR and their implementation.
38. In light of this investigation, ESMA expects EU TRs to put in place all necessary controls to ensure that they provide on-boarded regulators with the exact data they are entitled to receive according to EMIR and their mandate. In this respect, it is key that TRs do their utmost to capture the responsibilities and mandates of each on-boarded regulator accurately and monitor these over time.

1.2.3 Governance and Strategy

39. ESMA continued to actively engage with TRs regarding strategic governance, operational matters, and preparations for when the United Kingdom leaves the EU.
40. ESMA actively engaged with TRs through on-site visits. These visits enhanced understanding of the entity-specific governance and the strategic directions that TRs are taking. The objective of these visits was to engage on both strategic and operational matters with key staff, senior management and the Board. In general, throughout 2017 ESMA intensified its dialogue with supervised entities in line with their risk profile.

Competition and strategic decisions

41. BTRL and NATR entered the TR industry, albeit this has not yet lead to major changes in terms of market share or fees charged.
42. In terms of strategic direction, apart from further improving their core services offered under EMIR, TRs are likely to explore different possibilities to add value to these services or expand their businesses in new directions, such as SFTs or derivatives repository services in other jurisdictions. This seems to be driven by the fact that TR clients prefer to have easy access to a number of different services across the EU and other jurisdictions.

Transfer of data between TRs

43. ESMA issued the Guidelines on Portability in August 2017.⁵ The guidelines are establishing a consistent and harmonised approach to carry out the transfer of data between TRs. The guidelines cover the transfer of data at the request of a TR participant and the transfer of data due to withdrawal of TR registration.
44. The guidelines set out the basis to allow for a competitive TR environment, and to ensure high quality data is available to authorities. These data include the aggregations carried out by TRs, even in those cases where the TR participant changes the TR to which their derivatives are reported. They also establish a consistent and harmonised process to transfer records from one TR to another TR and support the continuity of reporting and reconciliation in all cases including the withdrawal of registration of a TR.
45. ESMA expects the Guidelines on Portability to better facilitate migration between TRs, and in turn induce competition by allowing counterparties to move to a different TR more easily. The consequences of these new guidelines on the competitive aspects of the EU TR industry will be monitored by ESMA during 2018.

Resources

46. Some TRs have progressed towards an optimisation of their resources in terms of staff, costs and technological solutions, while this remains for others a supervisory concern. It is important to note that TRs need to have sufficient and appropriate resources to fulfil their main obligations under EMIR. The level of resources dedicated to the TR business remains an area of concern for some TRs, particularly in light of upcoming regulatory changes such as SFTR. ESMA engaged with TRs throughout periods of staff turnover to ensure that TRs retained sufficient resources and suitably qualified staff. ESMA expects TRs to increase resources if they choose to expand their business into new reporting regimes.
47. In 2017, ESMA continued to regularly monitor the financial situation of the registered TRs based on the audited annual financial statements and interim financial statements submitted. The analysis suggests that TRs have sufficient buffers at least for 6 months of operational costs, in case they would find themselves in a critical situation.

1.2.4 Internal controls

48. ESMA focused on the internal control activities performed by selected TRs within the context of their system development lifecycle. More specifically, monitoring activities were directed towards TRs' sub-processes of managing software changes and software quality

⁵ https://www.esma.europa.eu/sites/default/files/library/esma70-151-552_guidelines_on_transfer_of_data_between_trade_repositories.pdf

assurance and testing. Controls and practices applied in these areas have a direct effect on the completeness and accuracy of the data that TRs are making available to the respective authorities or the early identification of potential issues before they affect production systems.

49. In this respect, and in line with its risk-based approach, ESMA assessed the relevant policies, procedures, methodologies and practices adopted and implemented by TRs in these areas. Further assessment and monitoring activities will be performed in 2018 in order to ensure that effective controls have been designed and implemented.

1.2.5 Compliance principles

50. ESMA has noticed some persistent concerns regarding the role of the compliance function across all TRs, such as insufficient resources and poor empowerment. In response, ESMA sent a letter outlining the following principles to each TR.
51. The Compliance function is a crucial risk and control function, and is expected to be established as part of an internal control system. Alongside other risk and control functions, the Compliance function is key to the way management maintains control over the TR's business activities. ESMA believes it is key for the Board of Directors and senior management of a TR to promote a culture of compliance. The governance of a TR should be established in a way that enables the Compliance function to operate independently and effectively. Compliance officers are expected to exhibit the highest level of objectivity and integrity in the performance of their tasks.
52. The Compliance function is expected to provide specialised skills and guidance to management and other TR staff and to evaluate the adequacy and effectiveness of internal controls in its area of responsibility. The Compliance function should ensure that all staff, including any staff assigned to support the TR's business at the group level understand the objectives and requirements of EMIR.
53. The Compliance function should be proactive rather than reactive in identifying issues and possible non-compliance through monitoring and/or assessment activities, and follow-up on their remediation. The Compliance function should have the competence to speak with all members of staff and to study any document, activity, file or piece of information that pertains to regulatory compliance. ESMA also expects that the Compliance function has adequate resources to perform its activities in an effective manner.

1.2.6 SFTR

54. ESMA published the final report on standards implementing the Securities Financing Transaction Regulation (SFTR) on 31 March 2017, which aims to increase the transparency of securities financing transactions.
55. These transactions include repurchase arrangements, securities lending, sell/buy-back transactions, and margin lending. The SFTR will require both financial and non-financial market participants to report details of securities financing transactions to a TR registered or recognised by ESMA. These details will include the relevant terms of the SFT transaction, the composition and characteristics of the collateral, the information on margins for cleared SFTs as well as the information on the reuse of collateral, cash reinvestment and funding sources. The SFTR implementing measures are expected to enter into force in the first half of 2018. Firms would be required to start reporting their SFTs to TRs 12 months after publication in the Official Journal of the EU. The reporting obligation will be phased in over 9 months.
56. ESMA has developed tools and analytical experience from the supervision of TRs and the analysis of EMIR data that can be applied to data reported under SFTR.
57. ESMA expects several current TRs registered under EMIR to apply for an extension of registration for SFTR. These applications for SFTR will be a key supervisory priority during 2018. In light of the anticipated applications for registration, ESMA is going through the relevant preparatory work required.

1.2.7 IT systems design and operation

58. TRs are technology-based market infrastructures and the robustness and reliability of their IT systems is an important driver of their ability to perform their duties under EMIR. Reporting entities, including counterparties, report derivative trades to TRs as prescribed by EMIR and the respective technical standards on reporting.⁶ Subsequently, reported information is validated, processed and recorded. Trade details are filtered according to the specific mandates of the authorities that are entitled to access them and finally a set of reports is generated and delivered to regulators. This process has to be implemented in a way that respects and supports EMIR requirements such as data accuracy, data integrity, data confidentiality and operational separation.
59. When considering the volumes of submissions TRs receive on a weekly basis (400 million) and the timeframes that must be respected (the data needs to be available to regulators

⁶ Commission delegated regulation (EU) No 148/2013 of 19 December 2012 and Commission implementing regulation (EU) No 1247/2012 of 19 December 2012

in a timely manner), it becomes clear that automation of all or most parts of the process is necessary and the reliance on the various IT system components for complete and accurate processing is essential.

60. In 2017, as part of its on-going TR supervision ESMA dedicated significant attention to the TRs' efforts towards achieving smooth and reliable systems operation. This has been achieved through interactions with supervised entities at various levels within their organisations, an in-depth investigation, active monitoring of TR incidents and material changes and thematic reviews.
61. In addition, certain TRs have initiated or concluded in 2017 material changes, which relate to their systems architecture. The relevant re-architecture projects aimed at better supporting the introduction of the revised RTS on reporting, the improvement of existing data quality capabilities as well as the achievement of cost efficiencies.
62. ESMA had closely monitored the implementation of these projects by having regular progress meetings with TRs' management and technical teams and by receiving progress reports and information about issues, risks and deviations from the project plan and milestones set. ESMA also assessed the relevant project governance aspects in terms of clarity of roles and responsibilities, project ownership, Board awareness, involvement and support, senior management direction and project management structure and activities.

1.2.8 Information security and cyber security

63. With respect to information and cyber security, ESMA receives periodically information about system and network penetration tests, security assessments, audits and vulnerability assessments performed by TRs. Any relevant incident is also notified to ESMA. During 2017, the information collected by ESMA and reported by TRs was assessed and potential findings were followed-up for further analysis or appropriate remedial action.

1.2.9 Book of Work

64. ESMA continued to monitor the book of work that was introduced in 2016. The book of work is a standardised template sent to ESMA from each TR outlining the scope, timeline, and progress of both ongoing and planned IT projects. ESMA found the completed templates to be highly informative in terms of increasing transparency and visibility on allocation and sufficiency of resources, current and planned TR development projects, priority setting, and timelines of actions.
65. ESMA supervision has developed metrics and indicators to monitor evolution and trends as regards the number of identified new fixes, the number of closed, cancelled and new issues, the average time and effort needed to perform a fix within and across TRs, as well



as the average time a software ticket remains open before being fixed. This tool is expected to provide ESMA supervision with early warnings on delays of fixes, inappropriate prioritisation or resource allocation issues.

66. Collected information is analysed periodically and feeds into ESMA's supervisory actions and engagement with TRs. The process has now been applied to all TRs.

2 Supervision of Credit Rating Agencies

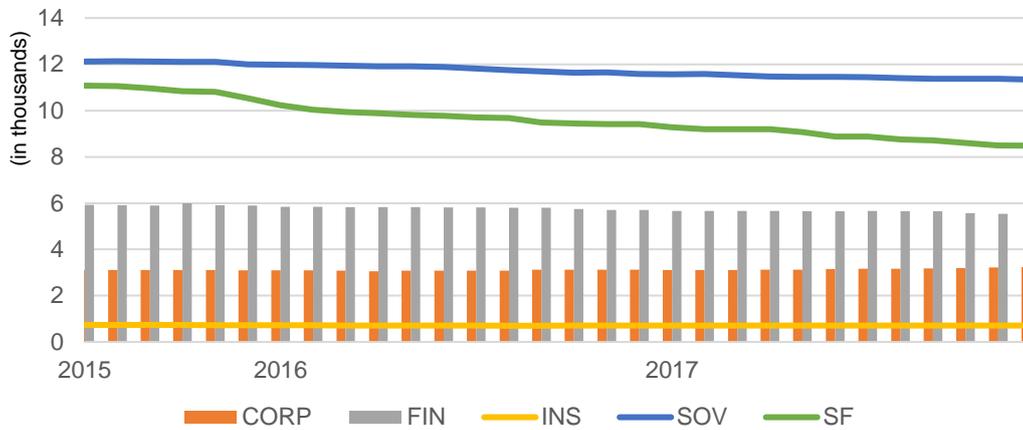
2.1 Industry state of play

2.1.1 Competitive dynamics and trends

67. Over the course of 2017, ESMA registered one new CRA and one registration was withdrawn, keeping the number of CRAs registered by ESMA stable: 26 registered CRAs and four certified CRAs. The CRA industry in the EU remains focussed around three large players. During 2017, a few smaller CRAs have been able to slightly increase their market share and number of mandates.⁷
68. ESMA notes that revenue-generation capacity and overall operating margins are significant for the largest CRAs operating globally. The smaller CRAs do not have the same market position as the three largest CRAs and as a result do not have similar operating margins.
69. As can be seen below in Figure 4, the number of financial instrument ratings outstanding issued by the largest three registered CRAs has remained approximately stable over the past years in the corporate, sovereign and insurance asset classes. However, structured finance instrument ratings have been gradually decreasing since 2015.

⁷ https://www.esma.europa.eu/sites/default/files/library/esma33-5-209 - cra_market_share_calculation_2017.pdf

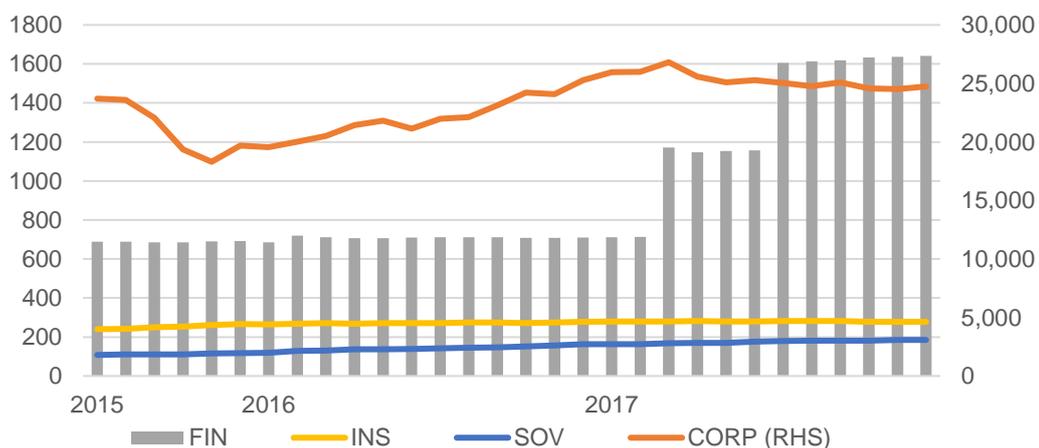
Figure 4 – Financial instrument ratings outstanding (three largest CRAs)



Source: ESMA RADAR database

70. Regarding SME CRAs, the number of issuer ratings outstanding has remained largely the same over 2017 in insurance ratings and corporate ratings outstanding. However, there has been a marked increase in the number of corporate financial ratings outstanding and a slight increase in sovereign ratings outstanding (see Figure 5).

Figure 5 – Issuer ratings outstanding (SME CRAs)



Source: ESMA RADAR database

71. One development that may challenge the nature of the CRA industry is innovation. Over the past years, significant breakthroughs have been achieved with respect to new technologies including machine learning and big data. For the moment, developments in these areas mostly take place outside the CRA industry. ESMA will follow closely the

effects of (technological) innovation on credit markets both in terms of structure of the market and potential new market participants.

2.1.2 Endorsement

72. Endorsement is a regime under the CRA Regulation, which allows credit ratings issued by a third-country CRA, and endorsed by an EU CRA, to be used for regulatory purposes in the EU. Endorsement is used by the largest CRAs operating in the EU. Currently, more than two thirds of the credit ratings that can be used for regulatory purposes in the EU are introduced through the endorsement regime. Nearly all endorsed credit ratings relate to non-EU issuers and financial instruments.
73. In light of the importance of credit ratings produced in third countries and used in the EU, it is key for ESMA to ensure that endorsed credit ratings fulfil the same high standards as credit ratings issued in the EU. Therefore, in 2017, ESMA updated its Endorsement Guidelines.⁸ The main changes to the guidelines relate to:
- Obligations of the endorsing CRA: when an EU CRA endorses a credit rating it must be able to demonstrate that the conduct of the third-country CRA that elaborated the credit rating fulfils requirements that are at least ‘as stringent as’ the EU requirements. ESMA will no longer consider this condition to be automatically met when a third-country CRA is based in a jurisdiction whose legal and supervisory framework has been positively assessed by ESMA. The new guidelines require that the endorsing CRA verifies and is able to demonstrate on an ongoing basis to ESMA that the conduct of the third-country CRA resulting in the issuing of the endorsed credit rating fulfils requirements which are at least as stringent as the relevant endorsement provisions of the CRA Regulation;
 - ESMA’s supervisory powers: ESMA clarified that it has the power to request periodical information directly from the endorsing EU CRA about an endorsed credit rating and the conduct of the third-country CRA; and
 - Objective reasons: when a credit rating is endorsed, there must be an objective reason for elaborating the rating outside the EU. ESMA provided transparency on how it assesses this requirement.
74. The Endorsement Guidelines will take effect on 1 January 2019, in order to give CRAs sufficient time to adapt policies and procedures. This will also allow CRAs to take into account ESMA’s additional guidance on what it considers ‘as stringent as’ EU requirements. This guidance will be developed by ESMA in 2018.

⁸ https://www.esma.europa.eu/sites/default/files/library/esma33-9-205_final_report_on_the_application_of_the_cra_endorsement_regime_1.pdf

2.2 Supervision activities

75. For 2017, the main topics of ESMA's supervision of CRAs were quality of credit ratings, IT and internal controls and strategy and governance. In addition, ESMA announced it would perform work on risk assessment tools and the use of data reported by CRAs. Within these topics, ESMA identified a number of key areas of focus for 2017. The following sections provide an overview of the work performed by ESMA in these areas after an overview of some general supervisory activities.

2.2.1 General supervisory activities

Perimeter

76. Entities who aim to issue credit ratings in the EU need to be registered with ESMA. In order to ensure a level playing field and identify market participants issuing credit ratings without being registered, ESMA performs perimeter assessments. In this context, ESMA uses a variety of information sources including market participants, NCAs and ESMA's own assessments (e.g. periodic internet sweeps), to identify companies potentially providing credit rating activities without registration. Where necessary, entities issuing credit ratings without registration may be referred to ESMA's enforcement department. Throughout 2017, ESMA has assessed information from several companies to identify whether their activities fall within the scope of the CRA Regulation. ESMA has also concluded upon common positions with regard to the definition of a credit rating as provided in the CRA Regulation to maintain a consistent approach in assessing perimeter cases.

Registration

77. Over the course of 2017, ESMA received four applications for registration as a CRA. One application was withdrawn and one was approved. Over the course of 2017, ESMA also withdrew the registration of Feri EuroRating Services AG as it no longer performed credit rating activities and no longer existed as a separate legal person.⁹ Therefore, the total number of CRAs registered and certified in the EU remained the same as in 2016. The assessment of the two applications for registration received in 2017 are still ongoing at the time of publication of this report.

78. In its 2016 annual report and 2017 work programme, ESMA mentioned that an application received in 2016 was refused. The applicant subsequently appealed ESMA's decision to the Board of Appeal of the European Supervisory Authorities, which decided to dismiss the appeal and confirmed ESMA's decision refusing the registration as a CRA.

⁹ https://www.esma.europa.eu/sites/default/files/library/esma71-99-376_feri_eurorating_services_credit_rating_agency_registration_withdrawn.pdf

Day-to-day supervision

79. A significant part of ESMA's day-to-day supervision is dedicated to assessing the periodic information it receives from supervised entities. Supervised entities provide ESMA with information on a quarterly basis as set out in the Periodic Information Guidelines.¹⁰ This is an important source of information for ESMA's risk assessment. ESMA also uses the input from other stakeholders including issuers and investors.
80. Remedial action plans are established and agreed with a CRA and set out the main actions that a CRA has to take to remedy the supervisory concerns identified during an investigation. Another important part of ESMA's work relates to the implementation of remedial actions by CRAs and whether this addresses the supervisory concern or compliance risk identified by ESMA. In 2017, ESMA monitored and followed up on a number of remedial action plans following investigations into the rating process of a number of CRAs and investigations into potential conflicts of interest and validation of methodology practices. Remedial action plans are an important supervisory tool and closely monitored by ESMA in order to make sure that remedial actions are properly implemented and closed in due time.
81. As part of its monitoring activities in 2017, ESMA performed a series of one-day meetings with small and medium-sized CRAs. Under its risk-based supervisory framework, ESMA uses this tool to complement the risk assessment of smaller entities with a lower risk profile. ESMA used these full-day meetings as a discussion platform with senior staff and management of the CRAs on key areas of supervisory risk. ESMA further used these meetings to clarify its supervisory approach to certain key provisions of the CRA Regulation, for example regarding the independence of board members, the definition of independent non-executive board members and the segregation of duties as required by the CRA Regulation.
82. Another important source of information for ESMA are complaints on supervised entities and information received from whistle-blowers as they allow ESMA to understand industry concerns and identify potential cases of non-compliance with the objectives and specific provisions of the CRA Regulation. In addition, ESMA takes the information received into account in its risk assessment.
83. For these reasons, ESMA assesses all complaints and market information received and, where necessary, takes steps to address the identified concerns through its supervisory activities. In 2017, ESMA has received a number of complaints from market participants on the conduct, the rating process, the level of particular ratings and disclosure practices of CRAs.

¹⁰ <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609.pdf>

International cooperation

84. In order to achieve its supervisory objectives and due to the global nature of the larger CRAs' operations, cooperation with other supervisory authorities is an important aspect of ESMA's supervision. Therefore, ESMA is actively participating in the global supervisory colleges, which consist of ESMA and the main CRA regulators outside the EU for the three largest and internationally operating CRAs. The supervisory colleges facilitate information sharing and cooperation between supervisors operating in different jurisdictions.
85. International cooperation for the three largest CRAs has been intensified. The main supervisory authorities for CRAs have jointly discussed with senior management of the firms. Following the firms' entering of new markets, cooperation among supervisors for the three largest CRAs has been extended to other supervisory authorities. During 2017, ESMA also had bilateral interactions with regulators from third countries on smaller CRAs operating globally and on specific topics such as methodology disclosures and conflict of interests in shareholdings.

2.2.2 Quality of the rating process

86. The main objective of the CRA Regulation is to ensure that credit ratings are independent, objective and of adequate quality. As set out in the 2017 work programme, quality of ratings has been the focus of ESMA's supervisory activities regarding CRAs for 2017. ESMA has worked on numerous areas to enhance the quality of credit ratings.
87. In addition to a number of dedicated investigations and remedial action plans submitted by CRAs (as described below), ESMA has also followed-up on its thematic work into validation practices within CRAs and analyst rotation.
88. ESMA also continuously monitors credit rating trends and developments in credit ratings through the information reported by CRAs. To this end, ESMA uses a range of supervisory tools and statistical methods to examine the quality and accuracy of credit ratings. Where ESMA finds outliers or unexpected patterns in the data, it will gather more information and follow-up with the CRA where necessary. ESMA has done so on a number of occasions in 2017.

General

89. During 2017, ESMA launched dedicated supervisory work-streams on various supervised entities related to the quality of credit ratings. When ESMA identifies discrepancies in the implementation of CRA Regulation requirements across the industry due to a lack of clarity or potential misinterpretation of CRA Regulation requirements, peer comparison is a useful tool to promote good practices and ensure consistent approaches across the industry.

90. ESMA will act when it identifies that a CRA's practices may harm quality of credit ratings and ultimately financial stability and investor protection. In 2017, ESMA interacted with CRAs concerning the management and review of models and methodologies used by CRAs, the periodic review of credit ratings and disclosure practices related to several specific requirements of the CRA Regulation.
91. Through its interaction with CRAs, ESMA also identified inconsistent application across asset classes of the requirement to rotate analysts and other staff involved in credit rating activities. Therefore, ESMA published a Q&A in this area in November 2017 to ensure consistent application across the industry of this important provision from the CRA Regulation.
92. Over the course of 2017, ESMA has identified inconsistencies in the errors reported by CRAs with respect to their rating methodologies and their application. CRAs are required to report any error in its rating methodologies and their application to ESMA pursuant to the CRA Regulation. These errors should be reported whether or not they have an impact on the outstanding credit ratings of CRAs. These notifications are a valuable source of supervisory information as they allow ESMA to monitor issues in the credit rating process. In addition, they help ESMA to identify potential cases of non-compliance with the objectives and specific provisions of the CRA Regulation and determine supervisory follow-up actions where necessary.
93. For these reasons, ESMA assesses all notifications received and, where necessary, takes steps to address the identified concerns through its supervisory activities. Over the course of 2016 and 2017, ESMA has identified a number of issues in the error reporting process of CRAs and has communicated these issues to CRAs. ESMA will continue its work in this area in the coming year.
94. During 2017, ESMA identified a number of issues with respect to disclosure practices. In addition, ESMA received complaints from investors in this respect. Disclosure is key to ensure investors are properly informed and ESMA will act when it identifies that CRAs' disclosure practices could mislead users of ratings or investors. ESMA focused in particular on the completeness of press releases, where deficiencies were identified and discussed with the supervised entities. The main issues related to the lack of disclosure of key rating assumptions and the minutes of rating committees. Furthermore, ESMA found deviating practices in the timing of the publication of sovereign ratings. Therefore, ESMA provided clarification to registered CRAs on the timing of publication of sovereign ratings to promote a level playing field in the application of the CRA Regulation.

Portfolio risk

95. ESMA's portfolio risk assessment measures - by use of statistical means - the ability of a credit rating to rank in order issuers by relative credit risk. In addition, ESMA monitors large positive or negative shifts in ratings at asset class and individual entity level. From

a supervisory perspective, ESMA's risk assessment tends to focus on specific movements in ratings and large changes in credit rating distributions. Large rating changes in either direction (i.e. upgrades and downgrades) are not in themselves an indication that the regulatory requirements have been breached. However, these movements and shifts may be indicative of non-compliance in a number of areas such as methodology validation and development, internal controls, conflicts of interest and others.

96. Portfolio risk is still relatively high across all CRAs and, more specifically, among the largest CRAs operating globally. ESMA's approach is driven mainly by large downgrades in certain asset classes.
97. As regards the portfolio risk of smaller CRAs, ESMA observes some areas of elevated risk. Some smaller CRAs experience a rapid expansion in the number of ratings outstanding and expansion of services to other (often analytically complex) asset classes. ESMA monitors these developments closely and takes supervisory actions where necessary and proportionate.

Validation Guidelines

98. The Validation Guidelines¹¹ provide a clarification of ESMA's expectations on the use of quantitative and qualitative measures in validating methodologies, establishing minimum standards in a significant area of the Regulation where ESMA has seen significant divergences in market practices.
99. In follow-up to the publication of the Validation Guidelines, ESMA sent a letter to all CRAs to highlight the importance of the subject, which included a questionnaire for CRAs to explain their implementation of the Validation Guidelines. The results of the questionnaire have allowed ESMA to review the implementation of the guidelines by CRAs and identify any supervisory action in line with ESMA's risk-based approach.
100. The questionnaire also enabled ESMA to undertake a review of the impact of the guidelines on CRA practices and the effectiveness of the guidelines as a supervisory tool. ESMA found that in general, CRAs have made efforts to meet the guidelines. A majority of CRAs reported a change to their processes due to the guidelines, and no CRA has been identified as not meeting ESMA's expectations in all of the areas.
101. Most CRAs meet ESMA's expectations in demonstrating historical robustness, discriminatory power and predictive power. Areas where CRAs are identified as having continued weaknesses include the articulation of 'limited quantitative evidence' for their validation practices, the identification of systemic vs non-systemic anomalies, and in establishing challenging thresholds as part of the validation process. In addition, one or

¹¹ https://www.esma.europa.eu/sites/default/files/library/2016-1575_guidelines_on_cras_methodologies_1.pdf

more CRAs that are not meeting ESMA's expectations with respect to the demonstration of predictive power.

102. Quite a lot of CRAs (14) identified themselves as only having limited quantitative evidence portfolios, meaning that they do not have to demonstrate the predictive power of the methodology (i.e. that the methodology produces ratings that meet the CRA's expectations for how their ratings will behave). These CRAs are therefore more likely to perform validations that are, on balance, more qualitative than quantitative. It is for a CRA to define for itself what it considers to be a 'limited quantitative evidence portfolio'.
103. ESMA observed a high degree of divergence in CRAs' definitions of what is a 'limited quantitative evidence portfolio'. For example, some CRAs identified the trigger for a limited quantitative evidence portfolio to be ten or less ratings, some at least ten default events, while others would require at least 50 default events in order for a portfolio not to qualify as having limited quantitative evidence. Some CRAs, rather than identifying a methodology as being of limited quantitative evidence, have instead established a threshold for when a statistical measure would produce meaningful results to demonstrate predictive power per rating category. ESMA notes that validation, and the validation of limited quantitative evidence portfolios in particular, is an evolving discipline and one where innovative practices and consensus on good practice is still developing. ESMA will continue to work with CRAs to identify best practice in the validation of limited quantitative evidence portfolios.
104. The questionnaire has enabled ESMA to review efficiently CRAs' practices after publication of the Validation Guidelines so that ESMA has an up-to-date overview and allowed ESMA to rank CRAs by risk level. This ranking will be used to identify supervisory actions that ESMA will take in cases where CRAs fall below the standards set by the CRA Regulation and the Validation Guidelines.

Methodologies and rating process

105. Methodologies are at the heart of the rating process and need to ensure the consistency and quality of credit ratings issued by CRAs. ESMA expects that methodologies guide the analytical judgment to ensure that the analysts' assessment is consistent and complete. CRAs should strike a balance between rigorousness, systematic application and continuity of methodologies. Due to the importance of methodologies, the process to change a methodology is key and should adhere to the requirements of the CRA Regulation.
106. In 2017, ESMA conducted a number of targeted investigations into the rating process of CRAs. One of the investigations focused on how a CRA dealt with changes in analytical approach. Areas of focus were rigorousness of the CRAs' methodologies, the thoroughness and accuracy of the rating analysis, the adherence to published

methodologies and their change process, the absence of conflicts of interest and the efficiency and adequacy of internal controls.

107. For this investigation, ESMA conducted an unannounced on-site investigation and used forensic tools as anticipated in the 2017 work programme. ESMA found issues with respect to the boundaries between methodologies and analytical judgement and the change process of methodologies. ESMA made clear that methodologies should provide a clear framework and define the boundaries of the analytical judgement. In this context, it is important to strike the right balance between rigorousness, systematic application of methodologies, their continuity and analytical judgement. As regards the process to change methodologies, CRAs should have a robust process in place to identify changes and their materiality. This process should also capture any market developments that may necessitate a change in any criteria article.
108. Another important issue that ESMA found relates to interactions between CRAs and issuers. Although such interactions occur during the rating process, CRAs should refrain from providing indirect indications on the course of action issuers should follow, as this might constitute advice.
109. As regards the role of compliance, ESMA found that compliance should play a more visible and decisive role in (i) advising a CRA's staff about regulatory requirements and (ii) assessing the conclusions and suggested enhancements put forward by other control functions and the business functions.
110. ESMA also conducted an investigation into the rating process of a CRA for the issuance of structured finance ratings. In this investigation, ESMA focused on various aspects of a methodology applicable to different types of structured finance ratings. The investigation focused on compliance by the CRA with certain key provisions of the CRA Regulation regarding methodologies, the internal control mechanisms linked to the issuance of structured finance ratings and the arrangements for maintaining adequate records.
111. As a result of the investigation, ESMA identified a number of risk areas and requested the CRA to, among others, improve the transparency and internal guidance of key parts of its methodologies, including the qualitative and quantitative factors that drive the analytical process and their relative importance. In addition, ESMA requested that the CRA's internal review function conducts regular reviews of general methodologies in line with the Validation Guidelines, takes measures to improve clarity of rating reports and performs regular checks on the effectiveness of such measures.
112. Another important requirement of the CRA Regulation relates to the monitoring of credit ratings and the review of credit ratings and credit rating methodologies on an annual basis (every six months for sovereign credit ratings). Having a thorough process in place for this ensures credit ratings remain up to date. ESMA has identified diverging practices in

the application of this provision by CRAs and will follow-up on this issue in the course of 2018.

2.2.3 IT and internal controls

113. IT and internal controls have been an important topic for ESMA in 2017, driven by the high levels of risk identified in these areas in the 2016 risk assessment. In order to assess the effectiveness of the internal control and the IT and information security risk, ESMA has performed the following:

- finalised its IT, information security and internal control risk assessment framework thereby applying a more structured approach to assessing those risks, in the context of its annual risk assessment;
- assessed the periodic information entities submit regarding compliance reports, compliance assessment reports, internal audit reports (where available), ERM or risk management procedures and risk dashboards, organisational changes regarding internal control functions, IT governance and strategy, IT and information security incidents and project plans of significant business and IT projects; and
- met with key staff within the compliance, internal audit, risk management and technology and information security functions.

Information Technology process and systems

114. ESMA's work in this area has focused mainly on revisiting the highest IT risk areas that were identified in the 2015 IT risk assessment, complemented with information ESMA receives periodically on the IT governance, strategy and organisation, as well as incidents and other performance issues. These risk areas were communicated to CRAs in the beginning of 2016 and included IT governance and strategy risks, information security risks, IT systems development and project management risks, as well as IT operations risk (e.g. IT outsourcing and ageing infrastructures).

115. Although this is an on-going area of focus, in 2017, ESMA has seen improvements in some of the IT and information security processes for a number of CRAs. There has for example been an increase of awareness of the Board regarding the importance of IT risks, as well as an increased and more informed involvement in the IT investment decision-making process. At the same time, ESMA has noted recurring performance issues and errors in the rating process, due to IT internal control failures.

116. Finally, a number of CRAs are undergoing important changes to their IT architecture and environment. Through its interaction with key staff, ESMA aims to monitor these projects where necessary and communicate any concerns from a supervisory perspective to the CRA.

Information security and cyber security

117. As regards cyber security, ESMA has been monitoring the cyber security threat landscape and any information security incidents the CRAs reported to ESMA. In the course of 2017, there have been two prominent worldwide incidents (Wannacry and Petya), and ESMA has specifically followed up with CRAs and TRs after the Wannacry incident, to determine if and how they had been affected, as well as their preparedness vis-à-vis these attacks. On multiple occasions, ESMA has stressed the importance of information security and its independence from IT departments and functions. In addition, ESMA has interacted with CRAs on their approaches to cybersecurity on a number of occasions in 2017.
118. ESMA identified issues relating to the adequacy or effectiveness of cybersecurity controls (often demonstrated by the frequency of attacks). In addition, ESMA has concerns regarding information security governance and information security incident management procedures. Furthermore, ESMA is of the opinion that information security is not always adequately considered in outsourcing arrangements and in the system development life cycle process.

Internal control

119. CRAs need to establish effective internal control arrangements, monitor and evaluate the effectiveness of their systems and internal control mechanisms and take appropriate measures to address any deficiencies in these areas. An effective internal control system is key for a CRA to be able to meet the objectives of the CRA Regulation and minimise the risk of conflicts of interest, loss of independence and objectivity in credit rating activities and failures in the rating production and dissemination of ratings.
120. In addition to the cross-CRA and TR work on internal controls, ESMA has also monitored the implementation of a number of remedial action plans that were the result of investigations conducted in the past. Some of these remedial action plans had requested significant changes to be made by CRAs due to the issues identified during the investigation. Examples of remedial actions requested from CRAs are improvements in the effectiveness of internal controls, empowering and enhancing the internal audit and risk management process, clarifying the internal control functions' roles and responsibilities, as well as enhancing the effectiveness of the compliance function (e.g. by ensuring key performance indicators are put in place).
121. Finally, following an investigation into potential conflicts of interest in a CRA, ESMA has requested that CRA to strengthen its internal control framework and processes governing conflicts of interest and enhance its disclosure of (potential) conflicts of interest with respect to credit ratings. In addition, ESMA is currently assessing the application of some key conflicts of interest provisions by one or more other CRAs.

2.2.4 Strategy and governance

122. As set out in section 3.3, Brexit is driving some of the important strategic and governance decisions that CRAs are taking in the EU. The organisational set up of some of the largest CRAs in the EU will be impacted by the UK leaving the EU. In addition, as set out in the 2017 work programme, some CRAs have been undergoing important reorganisations. ESMA continuously monitors the strategy and governance of CRAs by assessing the periodic information submitted by CRAs to ESMA. ESMA also has regular interactions with senior management and independent board members of CRAs to understand and assess the strategic direction and governance of CRAs.

Tone at the top

123. An important area for ESMA is the compliance culture within CRAs. Acting in a compliant manner and in line with the objectives and the spirit of the CRA Regulation is not something that is limited to the Compliance function. The entire organisation is responsible to ensure a compliance-oriented culture. ESMA regularly stresses this issue in its interaction with senior management and independent directors of CRAs.

124. A key requirement towards achieving a compliance-oriented culture is a robust internal control system but this is not sufficient by itself. Senior management should lead by example and should ensure to set the right tone when communicating with staff. This can be achieved by giving the right amount of attention to and communicate clearly on compliance issues occurring in the entity. Another good practice is to include compliance objectives in the evaluation of the performance of staff although this cannot by itself ensure compliance oriented behaviour by staff. Compliance should be an organisation-wide matter in both small and large CRAs.

Material changes

125. CRAs are required to notify any material changes to their conditions of registration to ESMA. These notifications can pertain to a wide variety of topics, including the opening and closing of branches, changes in business structure, personnel changes in the compliance and internal review function or appointment of new board members.

126. ESMA thoroughly assesses these notifications to ensure that the CRA still meets the conditions under which it was registered. If ESMA is of the opinion that the initial conditions for registration are no longer met, this could mean that the CRA needs to refrain from undertaking the change or re-apply for registration. It is therefore very important that CRAs pro-actively discuss complicated organisational changes or transactions in their early stages with ESMA and provide all relevant information.

127. In 2017, ESMA has assessed a wide variety of notifications, which included the operational integration of a CRAs' rating activities into that of another CRA following a

merger of the two companies. ESMA has also assessed spin offs of the credit rating activities from a group of companies.

128. In addition, ESMA has also received a number of notifications of material changes related to a CRA no longer meeting the conditions for exemptions that were granted when the CRA was registered. For example, if a growing CRA exceeds the 50 FTE thresholds, it should pro-actively notify ESMA that it no longer meets the conditions for the exemptions that were granted at registration. In these cases it is also important for CRAs to notify ESMA as soon as possible so ESMA can withdraw the exemption in a timely manner.

2.2.5 CRAs – Enforcement

129. In 2017, ESMA has taken one enforcement decision related to two breaches by Moody's Germany and Moody's UK of the CRA Regulation, regarding their public announcement of certain ratings and their public disclosure of methodologies used to determine those ratings.

130. Both infringements refer to rating actions which Moody's Germany and Moody's UK issued on nine entities described collectively by Moody's as supranational entities. In particular, between 1 June 2011 and 16 December 2013, nineteen ratings were issued by the relevant CRAs on such supranational entities (Relevant Ratings). Moody's Germany issued sixteen of these ratings and Moody's UK the other three.

131. The nine rated entities were the European Investment Bank, the European Investment Fund, the European Financial Stability Facility, the European Stability Mechanism, the Council of Europe Development Bank, East African Development Bank, European Company for the Financing of Railroad Rolling Stock, European Atomic Energy Community, and the EU.

Infringement concerning the presentation of ratings

132. The CRA Regulation requires that CRAs, in their announcements presenting ratings to the public, among other things: (a) clearly indicate the principal methodology or version of methodology used in determining the rating, and (b) provide a reference to a comprehensive description of the methodology concerned. The public announcement of each of the Relevant Ratings included a press release, which constituted the only material source of public information on the Relevant Ratings.

133. Each of the press releases: (i) failed to indicate the principal methodology or version of methodology, (ii) failed to refer to the comprehensive description of the methodology, principal methodology or version of methodology used to determine each of the ratings concerned, and (iii) did not include a comprehensive description of the methodologies concerned.

134. ESMA's Board of Supervisors therefore found that Moody's Germany and Moody's UK infringed the requirements concerning presentation of ratings with respect to the Relevant Ratings published (respectively, sixteen times for Moody's Germany and three times for Moody's UK). ESMA's Board of Supervisors found that the two CRAs each committed this infringement negligently and fined Moody's Germany EUR 420 000 and Moody's UK EUR 160 000.

Infringement concerning disclosure of methodologies

135. The CRA Regulation requires a CRA to disclose to the public the methodologies it uses in its credit rating activities. The methodology used in each of the Relevant Ratings was not the subject of any separate prior public disclosure either before or after the public rating announcements. Moreover, none of the press releases in respect of the Relevant Ratings made full disclosure of the methodology used in each instance.

136. ESMA's Board of Supervisors therefore found that Moody's Germany and Moody's UK infringed the requirement concerning the public disclosure of the methodologies with respect to the Relevant Ratings published. Moreover, ESMA's Board of Supervisors found that the two CRAs committed this infringement negligently and fined Moody's Germany and Moody's UK EUR 330 000 each.

3 Common areas of supervision in 2017

137. As identified in the work programme, ESMA has worked on a number of common areas of focus for CRAs and TRs. In order to exploit synergies that exist between the supervision of these two types of supervised entities, ESMA has performed joint work on:

- Internal controls;
- Cloud computing;
- Brexit;
- Fees and ancillary services; and
- Risk assessment and supervisory tools.

3.1 Internal controls

138. During 2017, ESMA has continued to enhance its framework for specifying the requirements related to internal controls across CRAs and TRs. Internal controls play a key part in the organisation of CRAs and TRs and the quality and independence of their processes. In order to meet CRA Regulation and EMIR requirements, CRAs and TRs need to put in place strong compliance, governance and risk management practices.

Therefore, ESMA needs to set consistent and clear expectations with respect to internal control implementation within supervised entities.

139. As part of this work, ESMA has developed a comprehensive segregation of duties control matrix, which identifies the core CRA and TR processes, and highlights CRAs and TRs' functions and activities that, if combined, undermine independence, could generate conflicts of interest and potentially compliance risks. In addition, ESMA has incorporated these requirements into internal supervisory tools where necessary. The framework enables ESMA to have a complete and structured view of internal controls and provide a practical way to make supervisory assessments and set clear supervisory expectations for supervised entities.

3.2 Cloud computing

140. As announced in the work programme for 2017, ESMA has worked on identifying supervisory expectations for CRAs and TRs intending to or having already outsourced their services to cloud service providers. ESMA's supervisory expectations are building upon EBA's guidance on the use of cloud service providers by financial institutions.¹² The work is expected to be finalised in 2018.

3.3 Brexit

141. Currently, ESMA supervises six CRAs and five TRs established in the UK. Among the CRAs, S&P, Moody's and Fitch have legal entities established also in EU27. However, for all three of them the UK currently represents the main hub for the EU activity.

142. In 2017, ESMA has continued the work that it started in 2016 on the implications of Brexit. Immediately after the referendum, ESMA established early and continuous interaction with supervised entities established in the UK. Where necessary, ESMA also provided clarifications to supervised entities, to the extent possible given the uncertainties around Brexit.

143. Following ESMA's General Opinion of 31 May 2017¹³ - setting out general principles aimed at fostering consistency in authorisation, supervision and enforcement related to the relocation of entities, activities and functions from the UK - ESMA established a strategic direction for the entities falling directly under ESMA's supervisory powers. This resulted in a letter sent to UK-based CRAs and TRs, providing key messages and clarifications with regard to ESMA's expectations and also related to queries raised by

¹² <https://www.eba.europa.eu/regulation-and-policy/internal-governance/recommendations-on-outsourcing-to-cloud-service-providers>

¹³ https://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf

supervised entities. ESMA also requested and received CRAs' and TRs' contingency plans for certain scenarios, including the scenario where there will be: i) no transitional arrangement between EU27 and UK; and ii) no third country regime applicable (hard-Brexit scenario).

144. It appears that a majority of the relevant supervised entities intend to continue to provide services in the EU following Brexit. ESMA has made it clear to the supervised entities that the post-Brexit structure of TRs and CRAs must be as strong as the pre-Brexit structure. In order to comply with the relevant regulations, TRs and CRAs need to ensure that there is sufficient representation of operational and control functions in the EU.
145. During 2018, ESMA will continue to monitor the implementation of the Brexit plans of the supervised entities, to ensure that they are deployed in line with the above-mentioned principles.

3.4 Fees and ancillary services

146. ESMA continued its work on the fees and ancillary services project launched in 2016 with the purpose to clarify ESMA's expectations regarding the provisions relating to fees in the CRA Regulation and EMIR. The CRA Regulation requires CRAs to ensure that fees for the credit rating and ancillary services are not discriminatory and based on actual costs. EMIR requires TRs to provide non-discriminatory access and charge publicly disclosed and cost-related fees.
147. In conducting its reviews, further to the analysis of information publicly available and periodically submitted to ESMA by supervised entities, ESMA obtained additional specific information through dedicated requests for information sent to CRAs and TRs. In addition, ESMA held a roundtable with supervised entities to share initial findings, better understand how the provisions regarding access and fees have been interpreted by supervised entities to date and in particular, how supervised entities set their prices and how these fees relate to the costs of products and services offered. Following the roundtable, ESMA also received detailed feedback from various supervised entities.
148. During 2017, ESMA also maintained regular engagement with clients of CRAs and TRs and, more generally, with users of credit ratings and trade repositories services to collect their opinions and experiences on the fees they are charged.
149. Following the conclusion of its supervisory review, ESMA published a thematic report on fees charged by Credit Rating Agencies and Trade Repositories on 11 January 2018.¹⁴ The report provides supervised entities, their clients and other market participants with a

¹⁴ https://www.esma.europa.eu/sites/default/files/library/esma80-196-954_thematic_report_on_fees_charged_by_cras_and_trs.pdf

summary of ESMA's observations and clarifies ESMA's main supervisory concerns and supervisory focus going forward as well as the areas for improvement in CRAs/TRs practices.

150. The following are ESMA's key areas of concern across the CRA and TR industries with regard to the fee provisions and where improvements are needed in the CRAs/TRs' practices:

- Transparency and disclosure: CRAs/TRs need to ensure sufficiency and clarity of information provided to actual and potential clients as well as to ESMA, aiming at reducing the existing information gap between CRAs/TRs and other stakeholders. For CRAs (where public fee schedules are not mandated by the CRA Regulation), clients should be able to understand the key elements of the fee schedule, the reasons for deviations from it as well as the reasons of price increase/decrease. For TRs (where public fee schedules are mandated by EMIR), more transparency can still be achieved through reducing complexity and increasing comparability of TRs' fee schedules, as well as disclosing sufficient information to enable clients to estimate any additional reporting cost, including establishment of access and connection to a TR. On ESMA's side, more information is needed around CRAs/TRs' costs, price deviations and relevant internal controls established by CRAs and TRs.
- Fee-setting process, including cost monitoring and related controls: CRAs/TRs need to ensure that cost is a key pricing factor and sufficient controls are in place in order to demonstrate that the regulatory objectives are met.
- Interaction with related entities: CRAs/TRs need to ensure that group support and/or interaction with related entities do not conflict with the non-discrimination and cost-based/cost-related principles, and that ESMA has sufficient information to identify possible risks.

3.5 Risk assessment and supervisory tools

151. As set out in the 2017 work programme, ESMA has developed new supervisory tools in 2017. Most of the resources were spent on tools to develop and further improve the risk assessment process and framework. This allows ESMA to better identify and evaluate supervisory risks. The tool also facilitates decision-making and the allocation of supervisory efforts in line with ESMA's risk-based framework.

152. Other tools that ESMA has developed will allow it to more efficiently deal with information received like notifications of material changes, financial reporting and periodic information. In order to ensure that ESMA receives the right information and to better align the information received from CRAs with its risk framework, ESMA intends to update its



Periodic Information Guidelines and introduce similar guidance for TRs in the course of 2018.

153. ESMA has also spent considerable resources on further improving and implementing the various credit ratings databases. Extensive work was done to integrate the CEREP and RADAR databases and to improve the quality of the data received by ESMA through its RADAR reporting system. ESMA also continuously interacts with CRAs on these matters. ESMA has started using the data reported by CRAs to RADAR for supervisory purposes, for example to assess trends in the credit rating market, asset classes or to make other ad hoc analyses. The data reported by CRAs is also used by ESMA in the risk analysis of EU financial markets as a whole for financial stability purposes.

4 Supervision work programme for 2018

4.1 Introduction

154. In order to establish its annual work programme for CRAs and TRs, ESMA uses a risk-based approach. The risk assessment takes into account all the information available to ESMA, i.e. information collected from previous supervisory activities, (periodic) information reported by the supervised entities, information communicated to ESMA by NCAs, market participants and third-country regulators and information obtained through ESMA's own market intelligence.

155. ESMA's risk assessment takes into account risks at an entity level but also at an industry level. It builds on the observed market trends and current state of the CRA and TR industry in the EU. As described in sections 1.1 and 2.1, some of the industry-level factors that ESMA has taken into account in this year's risk assessment are the competitive dynamics, regulatory changes, and technological developments. Important to note is that ESMA continuously receives information regarding CRAs and TRs. This information is used to update the risk assessment of the supervised entities and may result in re-prioritisation over the course of the year.

156. In defining its supervisory actions to address the risks identified, ESMA does not use a one-size-fits-all approach but tailors its actions to the type of risk or challenge at stake, taking into account its urgency, size and complexity and the history of the supervised entity. In addition, ESMA differentiates its approach depending on the objective it wants to achieve. In some instances, ESMA adopts a thematic approach, which creates an opportunity to look at certain issues across entities and allows for peer comparisons. In other cases, where issues seem to be concentrated in one entity, ESMA takes more focused action like targeted letters, investigations, on-site inspections or engagement with senior management or board of the supervised entity.

157. For 2018, there is a strong need to prioritise supervisory activities due to a relatively large number of external factors that affect ESMA's supervision in 2018. The external factors that will be a key priority for ESMA's Supervision Department in 2018 are Brexit and the entry into force of SFTR. In 2019, ESMA expects to start the supervision of securitisation repositories pursuant to the entry into force of the Securitisation Regulation, which will necessitate preparatory work during 2018.
158. Based on its risk assessment and the external factors described above, ESMA will have a number of supervisory topics that are common across CRAs and TRs in 2018. These issues may be addressed through jointly run projects, although the supervisory approach and actions are tailored to the specificities of the different industries. The common areas of focus across TRs and CRAs for 2018 are: Brexit, fees and ancillary services, internal controls, cloud computing, the review of the Periodic Information Guidelines and development of supervisory tools.
159. In addition to the common areas of supervision, ESMA has identified areas of focus that apply to only CRA and TR supervision, which are described in sections 4.3 and 4.4. In addition to the areas described below, ESMA will also carry out general supervisory activities, e.g. the assessment of applications for registration and day-to-day supervision activities.
160. The following sections provide an overview of the work that ESMA will aim to perform in 2018 regarding these areas of focus, depending on whether resources are available. The overview starts with the common areas of supervision for both CRAs and TRs.

4.2 Common areas of supervision in 2018 across TRs and CRAs

4.2.1 Brexit

161. The coming year will be a key year in the preparation for Brexit for both CRAs and TRs. The contingency plans set up by CRAs will need to start being implemented in preparation for the eventuality of the UK leaving the EU in March 2019 without arrangements in place for an orderly withdrawal and without a transition period.
162. In 2018, ESMA will continue to engage with supervised entities to ensure that their post-Brexit set up ensures that the following principles are met:
- Supervised entities established in the EU27 should have appropriate human resources, processes, systems as well as adequate and effective governance arrangements and internal controls for the day-to-day management of their business.
 - The post Brexit set-up should not lead to letterbox registered entities in the EU27 or to situations where substantial activities or functions are conducted or



established outside the EU27, in a separate legal entity or in a non-EU branch of the EU27 entity.

- The post-Brexit set-up in the EU27 should be as strong as the pre-Brexit set-up in the EU28.

163. ESMA will apply these principles to a number of key areas, including decision-making capability, human resources and presence of support and control functions. In addition, supervised entities need to ensure that all necessary steps are taken on a timely basis to prevent any market disruption when the UK leaves the EU.

164. During 2018, ESMA expects to dedicate significant resources to Brexit, which includes the assessment of contingency plans and proposed material changes to supervised entities' structures. In addition, ESMA will also need to review applications for registration of new legal entities.

4.2.2 Fees and ancillary services

165. As set out in section 3.4, ESMA published a thematic report on its findings with respect to fees and ancillary services in the CRA and TR industry. In 2018, ESMA will continue to engage with both supervised entities and their clients to ensure effective application of the fee provisions (e.g. on costs, price deviation, controls in place). ESMA will explore possibilities to further clarify some areas and concepts (e.g. costs of services, comparability of TRs' fee schedules and distribution of rating content performed by CRAs' affiliates). ESMA may also decide to provide further supervisory guidance to ensure compliance with relevant requirements.

166. In its report, ESMA indicates how the information currently available to ESMA does not sufficiently enable ESMA to effectively supervise CRAs compliance with fee-related regulatory requirements. ESMA does not have sufficient information in relation to CRAs' costs, deviations from fee schedules and programmes or rating-related services provided by affiliated entities. Therefore, ESMA will consider the possibility of enhancing the periodic information and notifications it receives from CRAs to address the information gap (e.g. information on the costs used in the fee setting process, and material changes to fee schedule). This could be achieved through the revision of ESMA's Periodic Information Guidelines. ESMA may also consider the possibility to propose a revision to the Delegated Regulation on Fees at some point in the future.

167. ESMA also aims to enhance its knowledge and relevant information on rating-related products and services provided by the CRAs' groups as a whole, specifically when these products and services rely on the resources (including analysts) of the registered CRA. Therefore, ESMA will request on an ad-hoc or periodic basis the submission of relevant information from CRAs and related parties, as well as from investors and users of ratings. Overall, ESMA aims to gain sufficient clarity on the rating-related activities that could raise

risks to its supervisory objectives. At the same time, ESMA acknowledges that this is an area where clarity might be needed for both CRAs and other market participants at some point.

168. Regarding TRs, ESMA aims to increase transparency and usefulness of information provided in TR fee schedules. ESMA acknowledges that some objectives, such as increasing comparability and using consistent definitions in the fee schedules requires an aligned approach across TRs. ESMA will therefore explore whether further guidance on establishing key concepts and definitions to be used in TR fee schedules may be helpful.

4.2.3 Internal control framework

169. As mentioned in section 2.2.3, ESMA considers that an effective internal control system is a prerequisite for CRAs and TRs to meet their compliance objectives, either directly or indirectly. Building on its 2016 and 2017 work on internal control framework, ESMA will finalise its views regarding the implementation of an effective internal control system for CRAs and TRs, in line with the regulatory requirements of the CRA Regulation and EMIR.

170. Where possible and necessary, ESMA aims to provide clarity to supervised entities over its expectations in this area, stemming from the overarching principles set out in the relevant regulatory obligations. It should be noted however that, as mentioned in the Work Programme 2017, through this work ESMA does not intend to standardise internal control practices of the supervised entities, since it recognises that each organisation is different. While ESMA will identify key areas of concern, it remains the entities' responsibility to identify effective ways to implement their internal control framework, taking into account their own environment.

171. Specifically, having considered international industry practices, international and EU standards on internal control,¹⁵ the supervised entities' own internal control practices, as well as the European Commission's 'Internal Control Framework',¹⁶ ESMA will identify and communicate to the supervised entities high-level principles, regarding the effective implementation of at least the following areas:

- internal control environment, including organisational structure in accordance with internal control objectives;
- risk assessment and management process;

¹⁵ For example: COSO Internal Control – Integrated Framework, May 2013 © 2013, Committee of Sponsoring Organisations of the Treadway Commission (COSO), U.S.A. All rights reserved. Licensed for use by the European Securities and Markets Authority.

¹⁶ Communication to the Commission from Commissioner Oettinger, Revision of the Internal Control Framework, Brussels, 19.4.2017C(2017) 2373 final.

- internal audit or independent assessment process; and
- monitoring activities.

4.2.4 Cloud computing

172. As mentioned in the Work Programme for 2017, many of ESMA's supervised entities in both industries (TRs and CRAs) are considering to or have already outsourced services to cloud service providers. ESMA recognises the benefits of cloud computing not only as an IT outsourcing model, but also as an enabler of financial innovation; at the same time, ESMA is aware of the risks and challenges it entails.

173. In this context, ESMA intends to further build on its work of 2017, with the objective to explore the compliance risk of cloud computing outsourcing, with a view to formulate a clear supervisory response and strategy. In order to achieve this, ESMA will perform a stocktake on the actual cloud computing implementations of certain supervised entities (CRAs and TRs). This will allow ESMA to identify and where necessary communicate its supervisory expectations regarding this subject.

174. In identifying these expectations, ESMA will consider the EBA recommendations on outsourcing to cloud service providers.¹⁷ It will also consider international standards (e.g. ISO/IEC 17788:2014 Information technology — Cloud computing), industry leading practices, as well as supervised entities' existing cloud computing implementations and strategies.

4.2.5 Review of guidelines on periodic information

175. In 2018, ESMA intends to amend the Periodic Information Guidelines to be submitted to ESMA by CRAs¹⁸ and introduce guidance for periodic information for TRs.

176. Regarding the Periodic Information Guidelines, ESMA still observes diverging standards in terms of content and format of the information reported by CRAs. In addition, the current Periodic Information Guidelines are not well integrated and aligned with the new risk assessment framework that ESMA has put in place. In this light, ESMA aims to enhance standardisation and completeness of the information provided by CRAs. At the same time, ESMA intends to reduce the delay of submission for events of significant supervisory relevance.

¹⁷ <https://www.eba.europa.eu/regulation-and-policy/internal-governance/recommendations-on-outsourcing-to-cloud-service-providers>

¹⁸ https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609_cra_guidelines_on_periodic_reporting.pdf

4.2.6 Supervisory tools

177. As set out in the 2016 annual report, ESMA has developed new supervisory tools and instruments over the past few years to allow for supervision that is more effective. This process led to the establishment of a new risk assessment framework in 2017, ESMA will further refine and develop this risk assessment framework in 2018. The objective is to support the new framework with IT tools, where necessary to allow ESMA to perform a more granular, more consistent and continuous risk assessment.

178. As part of this work, ESMA will further intensify its work on the quality of the supervisory information it receives through discussions with CRA and TRs and will fully embed the data received into its daily supervisory and research activities.

4.3 Work programme for Trade Repositories

179. As a result of ESMA's risk assessment, different priority areas have been identified within the following themes:

- Data quality and access by authorities;
- Technology trends and internal control; and
- Strategy and governance.

180. ESMA will follow-up and expand on its work in these areas through individual and thematic investigations, in addition to ongoing monitoring of the TR activities, risks, and controls employed.

4.3.1 Data quality and access by authorities

181. Data quality remains a key area of concern for ESMA in general. The revised regulatory and implementing technical standards on reporting under Article 9 of EMIR (RTS/ITS) entered into force on 1 November 2017. This means that ESMA will need to monitor prudently the implementation of the new validation rules by TRs in order to assess their seamless and effective implementation. For this purpose, a newly developed re-validation script will be used as a tool for identifying issues and for supervising TRs as regards the implementation of the new data validation rules.

182. ESMA will continue to analyse and monitor the data and statistical information received from TRs via the data quality dashboard developed in previous years as well as further enhance the tool by incorporating new analytical and data visualisation features. The dashboard is updated on a monthly basis and summarises statistics that relate to the level of data quality across different dimensions. The current dashboard supports the monitoring of re-validations, rejections, public data, reconciliation information and other

data characteristics. This overview allows for the identification of data quality trends and persistent issues that would not otherwise have been discovered and allows ESMA to follow up on these issues in its supervision of TRs and in its interaction with NCAs.

183. The EMIR Data Quality Log was introduced in 2016 with the aim to i) prevent the replication of effort for several NCAs that may pursue similar issues with TRs in parallel, ii) increase transparency on the actions taken by ESMA supervision and NCAs towards data quality and iii) improve the efficiency of both the communication and the respective follow-up actions. This process involves collating data quality issue information from authorities in a clearer format through a standardised template. These issues are then gathered and prioritised by ESMA. The list of prioritised issues is then communicated to NCAs to allow for increased transparency for all outstanding issues. This process has proven to be an effective tool to increase the efficiency of the communication and cooperation with NCAs and other users of TR data regarding data quality issues.

184. In 2017, ESMA assessed the completeness and accuracy of the information reported through TRACE. The results of this comparison illustrated some of the differences between the pre-existing submission formats from the TRs with TRACE, such as varying counts of records, inconsistent timestamp reporting, and missing reports for certain action types. ESMA communicated these differences to TRs, and several fixes have subsequently been implemented. Currently, ESMA is conducting a similar analysis using data after the implementation of the revised regulatory technical standard to assess the impact of the transition to the new reporting standards and to identify other possible issues. This exercise will be complemented with additional activities in the context of TRACE Phase II and as regards the completeness and accuracy of ad-hoc queries sent to TRs.

185. In the context of its ongoing supervision, ESMA will also focus on the implementation by TRs of the relevant published Q&As and the guidelines on transfer of data between Trade Repositories.

4.3.2 Information technology and internal control

186. TRs are technology-based market infrastructures and the robustness and reliability of their IT systems is an important driver of their ability to perform their duties under EMIR. In the context of the recent system re-architecture projects implemented by TRs and the transition to the new reporting rules that came into force on 1 November 2017, ESMA will focus its supervisory activities on TRs policies, processes and internal controls that are in place in the areas of software change management and software quality assurance and testing.



187. These areas are directly linked with the quality of the data that TRs are making available to regulators. ESMA's recent risk assessment has demonstrated that there are still weaknesses to be addressed and improvements to be made.

4.3.3 Strategy and governance

188. ESMA will engage with the involved TRs to promptly identify and assess the impact of their strategic directions and to monitor how the entity specific governance allows for appropriate decision making in support of EMIR compliance.

189. ESMA will also continue to take a close look at the relationship between TRs and their parent companies. In particular, ESMA will actively monitor how prioritisation at group level has an impact on resources, IT developments and outsourcing arrangements that affect the TR.

190. In addition, ESMA will focus on management quality, for example by looking at the tone-at-the-top. This will be achieved by maintaining close and regular interaction with a number of key functions and bodies, including the board and senior executives at both supervised entity and parent company level.

4.3.4 TR risk management function

191. TRs should have the capability to identify analyse and mitigate operational risks and any other material business risk. The risk management function plays an important role to this effect and constitutes a fundamental component of the TRs' internal control system.

192. During the recent risk assessment performed by ESMA supervision, it was identified that there was no adequate information available to assess and evaluate the performance of TRs' risk management function.

193. In this respect and in the context of the respective risk-based approach to supervision and the relevant priorities set, ESMA will perform the necessary supervisory activities to collect required information and assess the relevant policies, procedures, methodologies, tools and operational characteristics of the TRs' risk management function in order to evaluate its performance and effectiveness towards risk identification and mitigation.

4.4 Work programme for Credit Rating Agencies

194. As a result of ESMA's risk assessment, ESMA has identified different priority areas within the following themes:

- Quality of the credit rating process;
- IT and internal control; and

- Strategy and governance.

195. ESMA will follow-up and expand on its work in these areas through individual and thematic investigations, in addition to ongoing monitoring of the CRAs' activities, risks, and controls employed.

4.4.1 Quality of the credit rating process

196. The main objective of the CRA Regulation is to ensure that credit ratings are independent, objective and of adequate quality. In order to achieve high quality ratings, the quality of the credit ratings process is key. A high priority for ESMA in 2018 will be to address any issues that may affect the quality of the rating process. In its risk assessment, ESMA has found indications that ratings were not based on a thorough analysis of all the relevant information available to the CRAs.

197. Another high priority area are outliers or unexpected patterns in credit ratings data. These trigger further supervisory work to understand the root cause. Examples of asset classes where there have been significant rating changes over the last year are the structured finance and sovereign asset classes. Over the course of 2018, in light of the relatively high level of risk that has been identified in this area, ESMA will closely monitor further developments and follow-up on a number of trends it has observed in the ratings issued by some CRAs.

198. In addition, ESMA has implemented supervisory tools that will allow it to better use the information reported through RADAR. This will allow ESMA to closely monitor trends, outliers or unexpected patterns in credit rating data and perform a regular in-depth analysis of rating actions throughout 2018. ESMA will use this data to follow-up with CRAs on the reasons for such patterns or outliers. In addition, as described in section 2.2.2 ESMA is running investigations in this area, which will be finalised in the course of 2018.

199. In its risk assessment, ESMA has also identified a high level of methodology and validation risk. With respect to methodologies, ESMA assesses all components of a credit rating methodology, including models and key rating assumptions as these are closely interlinked. This high level of risk is driven by issues that ESMA has identified regarding the models and methodologies used in the rating process and more specifically regarding model management, validation and the rigorousness of methodologies used by CRAs. As described in section 2.2.2 ESMA is running investigations in this area, which will be finalised in the course of 2018. Following the conclusion of these investigations, ESMA will closely monitor and interact with the CRAs in question regarding the implementation of any remedial actions that are considered necessary in light of the issues observed.

200. ESMA is also exploring the development of guidance that harmonises the presentation and content of the disclosures that accompany CRA's rating actions. This guidance has the potential to make a real and lasting impact on consumer and investor protection within



the EU by ensuring that the disclosures that accompany a rating action enable its users to effectively conduct their own due diligence.

201. As part of this, work and to the extent possible under the current legal framework, ESMA will also examine the possibility of improving the disclosure of environmental, social and governance criteria where they arise within CRA's methodologies, models or key rating assumptions.

Validation Guidelines follow-up

202. Another important area for ESMA in 2018 relates to the follow-up of the Validation Guidelines.¹⁹ The overall quality of the validation performed by CRAs is important to ensure high quality credit rating methodologies and credit ratings. ESMA has seen improvements in the process to validate methodologies although it has also identified weaknesses in the identification of systemic and non-systemic anomalies, challenging thresholds and limited quantitative evidence portfolio.

203. As described in section 2.2.2, the questionnaire that ESMA sent to CRAs regarding the implementation of the Validation Guidelines has enabled ESMA to rank CRA practices by risk level. This ranking will be used to identify the appropriate supervisory action in case CRAs fall below the standards set by the CRA Regulation and the Validation Guidelines.

4.4.2 IT & internal controls

204. In addition to the work on the common CRA and TR concerns in the area of internal controls, ESMA will focus on information and cyber security in 2018. As described in section 2.2.3, ESMA monitors any information security incidents that CRAs and TRs report to ESMA. Following the major worldwide cyber security attacks in 2017 and its risk assessment, ESMA has identified relatively high levels of risk as regards information security and business continuity planning for CRAs (see section 2.2.3).

205. In this context, information security will be a high priority area for ESMA in 2018. During the year, apart from the on-going monitoring on information security and cyber security issues, the key focus for ESMA is to further understand and assess the cyber security risks in the CRA industry. The objective is to develop a supervisory approach to cyber security. Results of this work will be published in the 2018 annual report on an anonymised basis.

¹⁹ <https://www.esma.europa.eu/press-news/esma-news/esma-finalises-guidelines-validation-and-review-cras%E2%80%99-methodologies>

4.4.3 Strategy and governance

206. Brexit and changes in senior management, concerns regarding the effectiveness and independence of INEDs and reorganisations, are the main causes of the relatively high level of governance risk that ESMA has identified in its risk assessment. In addition to the common TR and CRA work on Brexit, ESMA will closely monitor any material changes made by CRAs to their governance structures and assess whether these comply with CRAs' obligations under the CRA Regulation.

207. In addition, ESMA will focus on management quality, for example by looking at the tone-at-the-top. This will be achieved by having regular interactions with a number of key functions and bodies within CRAs, including the board, INEDs, and senior executives. ESMA will continue to stress the key role that these functions and bodies play in achieving compliance-oriented behaviour at all levels of the organisation. Where ESMA sees room for improvement, it will take appropriate supervisory action.

B. Monitoring of Third-Country Central Counterparties

5 Monitoring of Third-Country Central Counterparties in 2017

5.1 Recognition

208. According to Article 25 of EMIR, central counterparties established in third countries (TC-CCPs) can only provide clearing services to European clearing members if they are recognised by ESMA. In addition, under the Capital Requirements Regulation (CRR), EU credit institutions, investment firms and their third country subsidiaries may only benefit from advantageous capital treatment with respect to cleared derivatives transactions, when the CCP they are facing is recognised by ESMA. This has led 47 TC-CCPs to apply for recognition to ESMA²⁰ (as of 31 December 2017).

209. One of the conditions to be fulfilled for a TC-CCP to be recognised is the adoption by the European Commission (the Commission) of an implementing act determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that third country comply with legally binding requirements which are equivalent to the EMIR requirements, the so-called "equivalence decision". Another condition that needs to be

²⁰ https://www.esma.europa.eu/sites/default/files/library/list_of_applicants_tc-ccps.pdf.

respected is for ESMA to conclude cooperation arrangements with the relevant third-country authorities.

210. Following the adoption by the Commission of equivalence decisions for India, Brazil, New Zealand, Japan Commodities CCPs, United Arab Emirates and Dubai International Financial Centre in December 2016, ESMA concluded 7 MoUs²¹ with 10 different authorities²² and recognised 9 TC-CCPs in March, May and September 2017. An additional US CCP was also recognised in March 2017.

5.2 On-going monitoring

211. Whilst ESMA does not have, as such, direct supervision powers over TC-CCPs, ESMA has to monitor TC-CCP activity as stated in the ESMA Regulation²³ and in the context of EMIR²⁴ to ensure EU financial stability. In addition, ESMA should assess whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation.

212. Therefore, following the recognition of a TC-CCP, ESMA has the obligation to regularly monitor the range of activities and services that the TC-CCP provides in the EU, so as to be able to identify potential situations in which the recognition of the CCP should be reviewed. In the context of the CFTC, regulated CCPs ESMA also has to monitor the conditions set by the Commission in the equivalence decision.

213. For example, instead of adopting one of the EMIR Anti-Procyclicality tools CFTC regulated CCPs can choose to adopt equivalent measures, which one of them did. Therefore, to regularly check that equivalence is guaranteed, ESMA receives quarterly updates on the performance of the relevant CFTC regulated CCP regarding the stability and conservativeness of those measures.

214. To perform those monitoring tasks ESMA has decided to focus on the risks that are more likely to materialise and negatively impact the EU financial stability or orderly markets or cause harm to investors.

²¹ <https://www.esma.europa.eu/regulation/post-trading/central-counterparties-ccps>.

²² In some jurisdictions more than one authority is responsible for one CCP's supervision and in some federal countries each province/state has its own relevant authority or multiple authorities.

²³ Recital 43 of Regulation (EU) No 1095/2010: "In order to safeguard financial stability it is necessary to identify, at an early stage, trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. [ESMA] should monitor and assess such developments in the area of its competence and, where necessary, inform the EP, the Council, the [EC], the other [ESAs] and the ESRB on a regular and, as necessary, on an ad hoc basis."

²⁴ See for example recital 19 of the EC implementing act for Japan also states that "The [EC], informed by ESMA, should continue monitoring the evolution of the Japanese legal and supervisory framework for CCPs and the fulfilment of the conditions [laid down in Article 25(6) of EMIR] on the basis of which [the] decision has been taken."

215. To this end, for recognised TC-CCPs, ESMA has gathered information on interlinkages and exposures of EU entities with the TC-CCP. Leveraging on the CPMI public disclosure framework, ESMA has requested data covering six areas:

- The EU products, currencies and trading venues serviced by the CCP;
- The EU clearing members' activity within the CCP in securities and derivatives (exchange traded and OTC);
- The corresponding EU clearing members' exposures (default contribution, margin provision and power of assessment);
- Liquidity resources provided by EU entities to the CCP;
- Interoperability arrangements between the CCP and EU CCPs and
- Qualitative information on important changes at the CCP.

216. Under the relevant MoUs, ESMA has requested the assistance of the third-country authorities to obtain the above-mentioned information. The MoUs stipulate that requests for information should be made in a manner that is consistent with the goal of minimising administrative burdens. With this objective in mind, ESMA will keep on conducting such request for information on a yearly basis, while encouraging the third-country authorities to inform ESMA of any relevant change in the CCP activity as soon as the former becomes aware of it.

217. Further to the necessary steps of reviewing and checking the data received and issuing corresponding follow-up requests, ESMA has finalised its analysis on potential risks recognised TC-CCPs might bring to the EU and has identified the areas of monitoring focus for the following years.

6 Third-Country Central Counterparties monitoring work programme for 2018

218. The recognition of TC-CCPs is an ongoing task for ESMA. In this context, ESMA will assess that the remaining 15 applicant TC-CCPs, or any new applicant, meet the criteria for recognition established in EMIR and any additional condition established in the relevant equivalence decisions. ESMA will also review the recognition of the recognised TC-CCPs in case they extend their range of activities or services in the EU.

219. In the context of initial recognitions or of extensions of range of activities and services, ESMA will assess whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.



220. ESMA will also continue to co-operate with third-country authorities and analyse the data received to ensure that TC-CCPs comply on an ongoing basis with the EMIR criteria and equivalence conditions and that the services provided to EU entities do not expose the latter to undue risks.
221. In relation to the results of the data request of 2017, ESMA will keep on monitoring the indicators evaluating whether there are potential risks for the EU emerging from TC-CCP activity that are not properly addressed through the current schemes and if so, identify the most efficient way to tackle them.
222. The focus is on the level of TC-CCPs clearing activity in EUR and the corresponding share of EU entities and the level of resources provided by EU entities to TC-CCPs and ESMA will share the information received when relevant and permitted with other competent authorities in the EU.
223. With respect to Brexit and envisaged regulatory changes to deal with it and with other third countries, ESMA is closely following the legislative developments on the EMIR 2.2 proposal, although not directly involved in the negotiations. ESMA will also start preparing in 2018 for taking up the expected new tasks envisaged in the EMIR 2.2 proposal.