

20 February 2013

Ms Verena Ross  
Executive Director  
European Securities and Markets Authority

Per Electronic Submission

Dear Ms Ross

**CONSULTATION PAPER ON GUIDELINES AND RECOMMENDATIONS ON THE SCOPE OF THE CRA REGULATION (“THE DRAFT GUIDELINES”)**

Moody's Investors Service (“**Moody's**”) wishes to thank the European Securities and Markets Authority (“**ESMA**”) for the opportunity to comment on the Draft Guidelines. Moody's supports ESMA's efforts to clarify the interpretation of the scope of the Regulation on Credit Rating Agencies (“**the Regulation**”). In the Annex, we have addressed a few concerns with the Draft Guidelines as currently drafted through responding to the specific questions set out in the consultation paper. Our primary concern with the Draft Guidelines is that it would appear that ESMA is introducing, for credit rating agencies (“**CRAs**”), new standards extending beyond the scope of the Regulation. Furthermore, there are areas in the Draft Guidelines that seek to extend ESMA's supervisory authority over entities and activities not subject to the Regulation.

Finally, for completeness, in our responses to the questions posed by the Draft Guidelines, we also have raised concerns regarding the prefatory text introducing the relevant proposed guideline.

Yours Sincerely



**Olivier Beroud**  
Regional Head Europe, Middle East and Africa

## I. Obligation to Register

*Q1. Do you agree with the approach set out [in the Draft Guidelines] on the obligation to register?*

*Q2. What may be alternative/additional criteria to require registration and certification?*

Moody's has no comments with respect to the approach set out in the Draft Guidelines on the obligation to register.

## II. Credit rating activities and exemptions from registration

*Q3. Do you agree with the explanation of credit ratings provided in this document?*

*Q4. Do you believe that the intervention of rating analysts in the assessment of the relevant information is the key element to distinguish credit ratings from credit scorings?*

Moody's has no comments with respect to the approach set out in the Draft Guidelines which is consistent with our understanding that a critical component of any credit rating is the presence of a rating analyst applying substantial qualitative input into a rating-specific credit opinion. It is important, however, that sufficient flexibility is maintained in the definition and the resulting guidelines to allow for the practical application of the Regulation and the avoidance of capturing activities under the scope of the Regulation that would not otherwise be considered to be credit rating activities. To give effect to our comments, the Draft Guideline could benefit from minor amendments:

*35. Credit ratings, as defined in the CRA Regulation, ~~should~~ include ~~not just~~ quantitative analysis ~~but also~~ and sufficient qualitative analysis, according to the rating methodology established by the credit rating agency. A measure of creditworthiness derived from summarising and expressing data based only on a pre-set statistical system or model, without ~~any~~ additional substantial qualitative rating-specific analytical input from a rating analyst, should not be considered as a credit rating.*

## III. Private Ratings

*Q5. Do you agree with the explanation of private ratings provided?*

Moody's appreciates the proposal by ESMA to clarify the treatment of private credit ratings under the regulatory framework in the EU. Paragraph 38 of the Draft Guidelines contains an important principle that distribution of the private rating to a limited number of persons does not result in that rating losing its "private" status. We note that it is not proposed to incorporate this principle in the resulting guidelines which may lead to confusion regarding ESMA's administration of private ratings. We would therefore propose that this principle be included in the resulting guidelines.

Paragraph 42 places specific obligations on a credit rating agency ("CRA") to take steps to determine the issuer's intentions with regards to the distribution of the private rating. We have no objection to requesting an issuer to commit in contract to the private rating being kept confidential (subject to certain exceptions such as restricted distribution to only a limited number of parties as contemplated in the Draft Guidelines) and consider that a signed contract with an issuer including such a clause should

be regarded as sufficient for the purposes of identifying the intention of the issuer. Moody's does not believe it is appropriate to require a CRA to separately enquire into the intentions of the issuer and potentially refrain from issuing a private rating based on this judgment which may lead to different standards being applied by different CRAs.

We therefore propose the following amendment to paragraph 42

*42. In accordance with Article 2(2)(a), credit rating agencies should ensure that the agreements for the issuance of private ratings cover the duty of confidentiality and limitations on the distribution of the ratings, and the notification that private ratings may not be used for regulatory purposes in the European Union. ~~In issuing private ratings credit rating agencies should inquire whether the person who placed the order, as recipient of the private rating, has any intention to use the rating in a way that would bring it into the public domain or to use it for regulatory purposes. Where the credit rating agencies can reasonably conclude that a private rating is to be disclosed to the public, it shall refrain from issuing that rating.~~*

#### **IV. Establishment of Branches Outside of the EU by Registered CRAs**

*Q6. Do you agree with the approach taken in the text above regarding the establishment of branches of registered credit rating agencies outside the Union?*

*Q7. Do you agree that credit rating agencies should demonstrate that there is an objective reason to conduct certain credit rating activities in branches established outside the Union?*

*Q8. Do you agree that ESMA's capacity to deliver effective supervision would be impaired where credit rating agencies conducted entirely or prevalently important operational functions, and in particular credit rating activities, in branches outside the EU?*

The Draft Guidelines clarify that CRAs shall not establish branches in third countries to perform activities that are subject to supervision by ESMA if this prevents ESMA from conducting supervisory tasks in relation to those branches as set out in articles 23b to 23d of the Regulation. As ESMA recognises, branches do not have a legal personality apart from the EU-registered CRA and, therefore, the registered CRA is responsible for the activities in the branch located outside of the EU. Moody's has no objection to the principle underlying the Draft Guidelines being that a CRA should not seek to circumvent the Regulation by deploying analysts in branches outside of the EU. If this principle is applied in interpreting what would constitute an "objective reason", Moody's would agree with this approach. However, if the proposal would limit CRAs from utilising the rationale such as effective deployment of resources or the use of subject-matter "hubs", then this would be of concern to Moody's. It is important for a CRA to retain flexibility in the deployment of its resources in the most cost-effective and efficient manner but taking steps to ensure that the operations of the non-EU branch fully comply with the requirements of the Regulation.

#### **Prefatory text**

(a) Paragraph 44 suggests that CRAs should "preserve a correct and proportionate balance between the ratings produced in their EU offices and those issued in branches located outside of the Union". We fully support the assertion that CRAs should not maintain a "shell" in the EU. However, we are concerned that in adopting the standard of "correct and proportionate", ESMA might develop a subjective view of what it believes is "correct and proportionate". We believe this standard is too vague

and subjective and should not be a standard against which CRAs should be required to comply. Instead, the principle that CRAs should not establish branches to circumvent the Regulation should suffice as a regulatory principle.

(b) Paragraph 47 suggests that important operational functions should not be based in non-EU locations. Article 9 of the Regulation states that:

*Outsourcing of important operational functions shall not be undertaken in such a way as to impair materially the quality of the credit rating agency's internal control and the ability of ESMA to supervise the credit rating agency's compliance with obligations under this Regulation.*

In other words, the Regulation specifically contemplates the practice of CRAs outsourcing important operational functions even *outside* of the CRA. It is therefore unclear why a potentially more stringent test is being applied to performing functions *within* the same legal entity (i.e. a branch of the registered CRA). The result will be that important operational functions can be outsourced to subsidiaries and to third-party non-CRAs but the functions cannot be conducted within the CRA, through a branch. The principle that CRAs should not seek to circumvent the legislation by conducting activities through a branch is broad enough for ESMA to effectively exercise its supervisory remit. ESMA should therefore focus on, as contemplated in paragraph 49, whether the activities being conducted in the branch are conducted in a manner that impedes their ability to supervise the registered CRA.

(c) Paragraph 48 introduces the principle that CRAs will be required to maintain some level of compliance staff located in the non-EU branch. This is not a requirement under the Regulation. Moreover, Article 6(3) of the Regulation provides for an exemption from the requirement to maintain a compliance function if certain conditions are met by an applicant CRA. ESMA should not seek to introduce stricter requirements for branches of the same legal entity where an exemption under the Regulation might otherwise be available.

## V. Specific disclosure best practices

*Q9. Do you agree with the disclosure recommendations indicated above and with their remit?*

*Q10. Do you agree that credit scoring firms and export credit agencies that distribute their products to the public in EU should consider ESMA's suggested disclosures that such scores or ratings are not issued in accordance with the CRA Regulation?*

*Q11. Do you agree with ESMA recommendation that the credit scoring firms and export credit agencies retain full responsibility for the disclosure indicated above when their scores or ratings are distributed to the public in the EU via agreement with third parties?*

The Draft Guidelines include ESMA's recommendation that, as a best practice, credit scoring firms that distribute credit scores to the public in the EU provide clear and prominent disclosure that those scores are not credit ratings issued in accordance with the Regulation. We note that the Draft Guidelines under this subject heading are framed in the context of "best practices". It is unclear what status should be afforded to "best practices".

Notwithstanding the above, the Draft Guidelines, read together with the Regulation, confirm that credit scores fall outside the scope of the Regulation. We believe it would set a dangerous precedent for

ESMA to attempt to prescribe or recommend positive actions by entities not falling under the Regulation. A prime example of this extension of authority beyond the scope of the Regulation would be the proposal to effectively ban the use of the word “rating” by non-registered entities. Not only would this result in ESMA acting beyond its powers under the Regulation but also lead to unintended consequences given that the word “rating” is used extensively in common parlance. We recognise the desire for ESMA to provide clear guidance to the market identifying registered CRAs, however, we believe this is adequately achieved through the obligation of ESMA under Article 18(3) of the Regulation to publish a list of registered CRAs.

Finally, we note the wide use of the rationale of the need for ESMA to fulfill its obligation to protect consumers. Moody’s would like to reiterate that our credit ratings are designed for use by financial market professionals.

#### **VI. Enforcement of the scope of the CRA Regulation**

*Q12. Do you agree that ESMA should take action to prevent any entity from abusively distributing credit ratings in the EU?*

Moody’s has no comments with respect to the approach set out in the Draft Guidelines on the obligation to register.