

**CONSULTATION ON GUIDANCE ON COMMON STANDARDS FOR
ASSESSMENT OF COMPLIANCE OF CREDIT RATING METHODOLOGIES
WITH THE REQUIREMENTS SET OUT IN ARTICLE 8(3)**

COMMENTS FROM STANDARD & POOR'S RATINGS SERVICES

1. Introduction

- 1.1 Standard & Poor's Ratings Services ("S&P Ratings Services") welcomes the opportunity to comment on CESR Draft *"Guidance on the common standards for assessment of compliance of credit rating methodologies with the requirements set out in articles 8(3)"* (*"the Draft Guidance"*). We note that Article 8(3) provides that:

"A credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing".

- 1.2 We are broadly supportive of the regulatory aims of the EU Regulation in this regard. We are concerned, however, that the draft *"Guidance on common standards for assessing whether CRA methodologies comply with the requirements of Article 8(3)"* (*"the Draft Guidance"*) may lead to interference with those methodologies as is clearly prohibited in Article 23.1¹ of the Regulation. The Draft Guidance specifically runs counter to Recital 23 which clearly sets out the limitations to the Draft Guidance. Recital 23 reads:

"Credit rating agencies should use rating methodologies that are rigorous, systematic, continuous and subject to validation including by appropriate historical experience and back-testing. Such a requirement should not, however, provide grounds for interference with the content of credit ratings and methodologies by the competent authorities and the Member States"

- 1.3 In addition, there are certain issues of interpretation we seek clarification.

2. Possible interference with the content of methodologies

- 2.1 Paragraph 13 of the Draft Guidance rightly emphasises the need to avoid regulatory interference with the content of CRA methodologies. Nevertheless, paragraph 15(b) is potentially contradictory in this regard, by requiring CRAs to demonstrate that:

¹ Article 23.1 reads: *"In carrying out their duties under this Regulation, neither the competent authorities nor any other public authorities of a Member State shall interfere with the content of credit ratings or methodologies."*

"The methodologies are developed and elaborated so that they take into account all relevant data available to the CRA, including how the appropriate weight of each element of data was determined."

- 2.2 This statement suggests that supervisors should monitor and decide whether the "weight" given by CRAs to particular pieces of data is "appropriate". The use of the term "appropriate weight" is particularly concerning, as it implies that an "inappropriate weight" also exists. Yet we question how supervisors could determine such a "weighting" to be "appropriate" or "inappropriate" without approving or disapproving the content of the analysis, since deciding the "weight" to be given to different elements of data is a sensitive question of analytical judgement. Weighting can vary depending on the facts and circumstances. A factor can be more overwhelmingly important in one situation versus another.

- 2.3 Similarly, paragraph 16(c) requires CRAs to submit a:

"General description on the approach to determining the weightings of qualitative or quantitative factors within methodologies and as necessary more information on the weightings of specific methodologies and their respective impact on the final rating".

- 2.4 As with paragraph 15(b), it is unclear why CRAs should provide a general description of their approach to determining the "weightings" of qualitative or quantitative factors. This again ignores the fact that the attribution of "weightings" is matter of analytical judgement and raises the prospect of regulatory interference with the content of the methodologies.

- 2.5 We therefore suggest that paragraph 16(c) should be deleted, and that in paragraph 15(b) the words "... including how the appropriate weight of each element of data was determined" should be deleted. We believe the approach reflected in these provisions is unsuitable, in that it would not be appropriate for S&P Ratings Services to adopt methodologies that would seek to determine, in advance, the weight to be given to each individual piece of information (because this is a matter for analysts' judgement). It may be impossible to tell in advance all the different elements that could influence factor weighting. It is not realistic to determine in advance all the situations that could influence factor weighting. Certainly, it would be inappropriate for supervisors to seek to monitor how much influence each piece of information has over a final rating, because this would undoubtedly amount to interference with a CRA's analytical independence.

- 2.6 Paragraph 17(a) requires CRAs to demonstrate that:

"They have procedures so that pre-defined credit assessment methodologies are applied consistently in the formulation of credit assessments in a given asset class, such that different analysts or rating committees within the CRA would assign equivalent credit assessment to any given entity."

This reference to "*pre-defined credit assessment methodologies*" implies that CRAs must use particular types of modelling (such as credit modelling or credit scoring) which can be relied on to give consistent outcomes in all cases. We agree that it is desirable to design a system to produce consistent ratings but the reality is that a rating determination involves a measure of qualitative judgement. It is not realistic to think that a rating committee can always produce identical ratings.

2.7 Paragraph 17(c) is similar, in that it would require CRAs to show that:

"They have appropriate policies and procedures for reviewing situations when ratings diverge from the pre-defined methodology to ensure there are appropriate reasons".

Again, this requirement appears to assume that CRAs should use pre-defined methodologies which will determine the outcome of ratings, or at least be a principal factor in the final rating outcome. Although pre-defined methodologies may be used for certain purposes, they will not necessarily be the only factors that will determine a rating. It is not, therefore, surprising that a rating decision taken by a rating committee may "diverge" from the outcome that those methodologies may, in isolation, dictate. Although we use models in the process of making ratings, models are only part of the methodology used to determine a rating. When a final rating "diverges" from the model output it is because of a specific reason consistent with our criteria.

2.8 It would not in any event be appropriate for CESR to force CRAs to use pre-defined methodologies. Any such approach would go beyond the requirements of Article 8(3). More importantly, it would lead to interference with the content of ratings methodologies, in violation of Article 23(1). In the circumstances, we believe that paragraphs 17(a) and (c) must be deleted.

2.9 The introduction to Section 4A (top of page 5 above paragraph 15) states that "*CRAs have appropriate means for developing and reviewing credit rating methodologies and high standards of due diligence in utilizing them.*" We note that the EU Regulation does not require CRAs to perform due diligence functions and CESR should not impose such requirements now. In this section, CESR should clarify that "*relevant*" as used in paragraphs 15(b) and (d) means "which a CRA considers

relevant in accordance with its published methodologies”, as it would be inappropriate for supervisors to determine what is “relevant”,

3. Miscellaneous comments

- 3.1 We believe paragraph 16(a) should be deleted. The independent directors do not need to have an involvement in the development of the methodologies used by the CRA, but rather they have the specific task of monitoring that development. The independent directors should, in our view, have some degree of flexibility as to how they decide to discharge this function and the CRA should not establish policies that tell them how to.
- 3.2 Paragraph 16(n) would require CRAs to maintain detailed written procedures and policies to analyse the impact of changes to methodologies, to publicise any changes in methodologies and "*... potentially allow a period for public comment to the CRA, prior (sic) implementing these changes.*" We consider that this paragraph goes well beyond the requirements of Article 8(3). In particular, the EU Regulation does not require a CRA to engage in a process of consultation before changing its methodologies, and the steps that a CRA must take when changes are implemented are already set out in Article 8(6). The requirements proposed in paragraph 16(n) are not directly relevant to the outcomes expressed in Article 18(3), and CESR should not introduce these requirements through the means of guidance on the standards required under that Article.
- 3.3 We also note that much of the Draft Guidance (and in particular paragraphs 19 and 20) addresses the issue of business continuity. Although we acknowledge that Article 8(3) states that methodologies must be "continuous", we question whether the proposed guidance in paragraphs 19 and 20 is something that should properly be issued under Article 21(3)(b). In this regard, we note that Article 8(3) requires a CRA to maintain methodologies that are continuous, but not to maintain detailed procedures to support the continuity of its ratings activities. These procedures are instead required under a separate provision at Annex I, Section A, paragraph 8 (which does not fall within the scope of the matters that CESR should issue guidance on).

4. Questions of interpretation

- 4.1 We would welcome more guidance on the following points.
- 4.2 First, paragraph 15(a) requires there to be "appropriate controls in place between staff developing and updating rating methodologies and those responsible for issuing and monitoring ratings". It is not clear, however, what controls supervisors would view as "appropriate" in this regard, and how much practical separation there must be between those developing ratings criteria and those applying them. In any event we are not clear that a move by CESR and/or supervisors to dictate practice in this regard

(including stipulating who may or may not develop criteria and who may or may not participate in ratings committees) is consistent with analytical independence, as referred to in paragraph 1.2 above.

- 4.3 Secondly, it is not clear whether the "review function" referred to in paragraph 15(c) refers to the review of methodologies themselves and those who develop them, or to the review of the work of the analysts who apply the methodologies in producing ratings.