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Per Electronic Submission

Dear Mr Flinterman

Response of Moody's Investors Service to ESMA's Consultation Paper on Regulatory Technical Standards on the Assessment of Compliance of Credit Rating Methodologies with the Requirements set out in Article 8(3) of Regulation (EC) No 1060/2009

Moody's Investors Service (MIS) welcomes the opportunity to comment on ESMA's draft regulatory technical standards (RTS) in respect of Article 8(3). We note that ESMA proposes language that is considerably more concise than the respective CESR guidance. We welcome this adjustment made by ESMA, which takes into account the binding legal status of RTS.

Article 8(3) requires 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."* In its discussion, ESMA states that "Regulation (EC) No 1060/2009, in particular Article 23 thereof, does not permit ESMA, the Commission or any public authorities of a Member State to interfere with the content of credit ratings or methodologies. Accordingly, this Regulation lays down the rules by which those methodologies are to be assessed but does not permit those authorities to decide on [the] accuracy of a credit rating produced by those methodologies."[1] While we welcome Recital 6's clear emphasis of the prohibition, we nevertheless have two primary concerns.

1. Article 3 – Potential intrusion into analytical substance

As drafted, Article 3 of the RTS may be construed by both CRAs and market participants to empower ESMA to interfere with analytical methodologies. By way of example, Article 3(2) mandates credit rating agencies to list and "justify" to ESMA each qualitative and quantitative factor used in a methodology. Article 3(3) further mandates what would be considered acceptable means of "justification". In our view, such a mandate runs dangerously close to empowering ESMA to be the arbiter of the analytical merit of a methodology.

[1] Recital 6, page 8.

Rather than authorising ESMA to decide, ex ante, if a credit rating agency's methodology has incorporated "all factors relevant in determining creditworthiness of a rated entity or a financial instrument which shall be supported by statistical, historical experience or evidence",[2] we strongly believe that ESMA should seek to enhance the market's ability to judge whether the criteria of Article 8(3) are met. In this regard, we suggest that Article 3 instead should focus on

☐ CRAs' processes for creating, reviewing and modifying methodologies; and

☐ The transparent nature of CRAs' methodology publications to the market, so that market participants are well-positioned to assess analytical rigor.

2. Article 4 – Confounding of methodologies with models and assumptions

We note that the proposed Article 4 defines "systematic" as applying to methodologies as well as models and key rating assumptions. We acknowledge the importance of models and assumptions, where used within methodologies, but would request that a clear distinction is maintained: methodologies seek to capture the assumptions used. Models, in turn, are simply tools that may be used to help implement methodologies. The distinction is clearly recognised by Article 8(3) of the Regulation itself, which only addresses methodologies. The RTS should be accordingly aligned.

Finally, were ESMA to implement the RTS as drafted, we question its assessment of the benefit to the market. In particular, if CRA analytics were subject to validation or concurrence by regulators, we believe that it is likely that over time all CRAs would coalesce around one set of rating view and rating approach. This, in turn, would reduce the range of views and discussion about credit risk in the European market. Rather than improving the quality of credit analysis among CRAs, we are concerned that the RTS may in fact undermine and in the end homogenise analytical methodologies.

We set out our detailed comments, including the answers to ESMA's specific questions and alternative wording suggestions, in the Annex to this response. In view of the differences between the RTS and the previous CESR guidance, we furthermore suggest that ESMA suspend the current requirement for CRAs to provide ESMA with information on how we satisfy each item of the guidance within one month of registration, until finalisation of the RTS. CRAs should not be required to provide a detailed narrative in respect of guidance that is seen to be no longer appropriate in its current form, and is about to be superseded.

Yours sincerely

Frédéric Drevon
Managing Director and Regional Head of Europe, Middle East and Africa

[2] Article 3 (1)(b).

Annex - Responses to ESMA's questions and wording suggestions

Recitals

Recital (6) Regulation (EC) No 1060/2009, in particular Article 23 thereof, does not permit ESMA, the Commission or any public authorities of a Member State to interfere with the content of credit ratings or methodologies. Accordingly, this Regulation lays down the rules by which those methodologies are to be assessed but does not permit those authorities to decide on their accuracy of a credit rating produced by those methodologies.

This is an important consideration, which we support. We suggest a clarification as follows: "…but does not permit those authorities to ~~decide~~ opine on the substance of these methodologies or on the~~ir~~ accuracy of a credit rating ~~produced by those~~ developed within the framework of these methodologies".

Recital (7) Article 8(2) of Regulation (EC) No 1060/2009 provides that credit rating methodologies shall use all information available to a credit rating agency that is relevant to its analysis and shall include measures to ensure that information is of sufficient quality and from reliable sources.

Recital (8) Article 8(5) of Regulation (EC) No 1060/2009 requires a credit rating agency to monitor credit ratings and review its methodologies in particular where material changes occur that could have an impact on a credit rating.

Recital (9) Article 8(6) of Regulation (EC) No 1060/2009 requires a credit rating agency which changes its methodologies, models or key rating assumptions to immediately disclose the likely scope of credit ratings to be affected, review those affected credit ratings as soon as possible and, where necessary, re-rate all credit ratings that have been based on those methodologies, models or key rating assumptions.

Article 21(4)(d) of the CRA Regulation requires ESMA to draft regulatory technical standards in respect of Article 8(3), which is also the stated focus of the RTS. ESMA's mandate does not extend to sub-sections 2, 5, and 6. These recitals are therefore confusing and outside the scope of 8(3). We propose their deletion.

Subject matter and scope

Article 1.3 Credit rating agency shall demonstrate to ESMA its compliance with the requirements set out in Article 8(3) relating to the use of credit rating methodologies.

We agree with the principle, though we are concerned about a possible interpretation of this requirement which would force CRAs to provide a written explanation of each of their methodologies to ESMA, and in respect of all detailed RTS on Article 8(3). Methodologies provide the framework, identify the factors and explain the rationale for the relevance of those factors when a credit rating agency is assessing credit risk. As ESMA is aware, these methodologies are quite extensive and at times lengthy documents. Where ESMA requires further clarification as to how a methodology meets the criteria of Article 8(3), this would be best addressed through specific *ad hoc* requests, as also seems to be implied by the proposed Article 2.2.

We propose clarification as follows:

Article 1.3 <u>A c</u>~~C~~redit rating agency shall <u>at all times be able to</u> demonstrate to ESMA its compliance with the requirements set out in Article 8(3) relating to the use of credit rating methodologies.

Use of the rules by ESMA

Article 2.2 ESMA shall examine compliance by each credit rating agency with Article 8(3) of Regulation (EC) No 1060/2009 in relation to an application for registration under that Regulation and thereafter as ESMA sees fit.

We propose the deletion of the words "as ESMA sees fit", which imply an inappropriate level of discretion in applying clearly defined rules:

ESMA shall examine compliance by each credit rating agency with Article 8(3) of Regulation (EC) No 1060/2009 in relation to an application for registration under that Regulation and thereafter ~~as ESMA sees fit~~.

Article 2.3 In carrying out its obligation in Article 2(1), ESMA shall use all information relevant to the development, approval, use and review of credit rating methodologies.

There is no objectively "correct" way of developing methodologies. Rather, the current wording might be misunderstood as allowing ESMA to impose on CRAs its views in this respect.

We suggest amending as follows: "ESMA shall use all information <u>that ESMA reasonably considers to be necessary</u> to <u>assess</u> the <u>process of</u> develop~~ment~~<u>ing</u>, approv~~al~~ing, us~~e~~<u>ing</u> and review<u>ing</u> ~~of~~ <u>its</u> credit rating methodologies."

Article 2.4 In determining the appropriate level of assessment, ESMA shall consider whether a credit rating methodology has a demonstrable history of consistency and accuracy in predicting creditworthiness and may have regard to methods of validation such as appropriate default or transition studies designed to test that specific methodology.

A methodology merely provides a framework for the rating process. Accuracy tests can only be conducted with respect to the ratings that are developed in application of the methodology, not on the methodology in isolation. Further, it is unclear what ESMA intends by the use of the phrase "appropriate level of assessment."

We propose amendments as follows:

~~In determining the appropriate level of assessment,~~ ESMA shall consider whether the ratings developed in application of a credit rating methodology ~~has~~ have a demonstrable history of consistency and accuracy in predicting creditworthiness and may have regard to ~~methods of validation such as appropriate~~ default or transition studies ~~designed to test that specific methodology~~ for this purpose.

Rigorous

Question 1: Do you agree with the list of requirements set out in the attached draft RTS to assess whether a credit rating methodology is rigorous?

The proposed principles partly seem to rely on a misunderstanding of the nature of methodologies. Methodologies are intended to provide a framework for the analysis of credit risk and to guide analysts in their thinking, in order to support dynamic, qualitative, and judgment-based credit analysis. Methodologies cannot be applied in any automatic or static way, as appears to be implied by some of the proposed requirements. Indeed, the proposed RTS place particular emphasis on quantitative criteria. However, the qualitative elements of the rating process are at least as important as the quantitative ones. In the end, credit ratings are a subjective perspective on future creditworthiness. By their nature, they cannot be rigidly automated.

Specifically, we suggest the following amendments:

Article 3.1 A credit rating agency shall use credit rating methodologies:

(a) that are clear and robust controls and processes for its development and approval that allow for suitable challenge.

(b) that incorporate all factors relevant in determining creditworthiness of a rated entity or a financial instrument which shall be supported by statistical, historical experience or evidence.

(c) that take into account the modelled relationship between rated entities or financial instruments of the same risk factor and the modelled relationships between risk factors.

(d) and their associated analytical models, key credit rating assumptions and criteria that are reliable, relevant and of sufficient quality.

As we understand the proposed provisions, points (a) and (b) seem to confuse the process for developing methodologies with their substance. Point (c) seems to assume that models are used in all methodologies, which is however not the case. Point (d) exceeds the scope of ESMA's guidance. The specific assumptions underlying a rating would not normally be part of a methodology, but are best addressed in a rating announcement.

We therefore propose re-wording as follows:

(a) A credit rating agency shall apply robust processes and controls to the development and approval of credit rating methodologies. In developing a methodology, a credit rating agency shall take into account the qualitative and quantitative factors that it considers, whether as a result of quantitative analysis or credit judgment based on experience, to be the most important for determining the creditworthiness of a rated entity or transaction.

(b) Methodologies shall set out clearly the credit rating agency's approach in assessing credit risk in the market segment covered by the methodology, in a way that allows market participants to identify what the credit rating agency expects to be the most important assessment factors that will be taken into account in the rating process.

(c) Methodologies shall also set out the way in which models and key assumptions, as applicable, are used in the rating process.

> *Article 3.2 A credit rating agency shall list and justify for the credit methodologies used:*
>
> *(a) each qualitative factor, including the scope of qualitative judgment for that factor; and*
>
> *(b) each quantitative factor, including key variables, data sources, assumptions, modelling and quantitative techniques.*

This Article seems to require CRAs to provide a separate summary and justification of each of its methodologies. We see no benefit in terms of the rigour, consistency or transparency of our methodologies or ratings from undertaking this piece of work as each methodology is already intended to be a clear, comprehensive and self-standing explanation of how we propose to rate particular types of transaction, and why. The relevance of different factors should be clear to any interested party without reference to any other documents. Moreover, it is unclear to whom such justification must be made. The implication of the article is that CRAs should justify their methodology to ESMA. If this is the intent, the article intrudes into CRAs' analytical independence.

We suggest wording as below, to further build on our suggestion for Article 3.1 above (new language underlined):

(b) Methodologies shall set out clearly the credit rating agency's approach in assessing credit risk in the market segment covered by the methodology, in a way that allows market participants to identify what the credit rating agency expects to be the most important assessment factors that will be taken into account in the rating process. <u>This shall include a clear explanation of the relevance of all qualitative and quantitative factors.</u>

(c) Methodologies shall also set out the way in which models and key assumptions, as applicable, are used in the rating process. <u>This shall include a description of such models and key assumptions, as well as a specification of the sources of any data used within the methodology</u>.

> *Article 3.3 The justification in paragraph 2 shall include the following:*
>
> *(a) an explanation of the importance of each qualitative or quantitative factor used within that methodology including, where relevant, a description of and justification for related weightings assigned to those factors and their impact on credit ratings;*
>
> *(b) the interrelationship between macroeconomic data and its impacts on the key assumptions used in that credit rating methodology; and*

(c) an assessment of the interrelationship between the key credit rating assumptions and the volatility of credit ratings over time.

As noted above, each methodology should in itself be clear and self-explanatory. The substantial requirements expressed in subparagraphs (a) and (c) should in essence be covered by the language we propose above for Article 3.1, in respect of the methodologies themselves.

As regards subparagraph (b), macroeconomic data are of limited relevance to most methodologies since ratings are, by construction, meant to be stable through the economic cycle.

We propose deletion of Article 3.3.

Article 3.4 A credit rating agency shall use credit rating methodologies and their associated analytical models, key credit rating assumptions and criteria that promptly incorporate findings from an internal review undertaken by:

(a) the credit rating agency's independent members of the administrative or supervisory board;

(b) its review function; and

(c) or any other relevant person or committee involved in the monitoring and reviewing of credit rating methodologies.

It is not the Board's function to be involved in the development of methodologies. We furthermore suggest amendments to the proposed wording to recognise that a methodology will be amended when observations made by some parties in its respect are recognised as relevant by a wider number of people, rather than in any automatic way. Amendments will therefore be made as and when they are found to be appropriate, i.e. in a timely manner, rather than "promptly" which would instead imply a risk of over-reacting to new findings. Also, the RTS in respect of Article 8.3 should strictly speak to the methodologies, but not models or assumptions:

4. A credit rating agency shall <u>have processes in place so that</u> ~~use~~ credit rating methodologies<u>, in a timely manner,</u> ~~and their associated analytical models, key credit rating assumptions and criteria that promptly~~ <u>take account of</u> ~~incorporate~~ findings from an internal review undertaken by~~:~~

~~(a) the credit rating agency's independent members of the administrative or supervisory board;~~

~~(b)~~ its review function~~; and~~

~~(c)~~ or any other relevant person or committee involved in the monitoring and reviewing of credit rating methodologies.

Systematic

Question 2: Are there any other requirements that should be considered in the assessment of whether credit rating methodologies are systematically applied?

Article 4.1 A credit rating methodology and its associated analytical models, key credit rating *assumptions and criteria shall be applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it.*

We do not believe that there are any other requirements to be considered in respect of the criterion of "systematic" methodologies.

We note however that the proposed language exceeds the scope of the RTS, which should be confined to methodologies. We propose deletion of "and its associated analytical models, key credit rating assumptions and criteria".

Proposed amendment: A credit rating methodology ~~and its associated analytical models, key credit rating assumptions and criteria~~ shall be applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it.

Continuous

Question 3: Do you agree with the list of requirements set out in Article 5 defining whether credit rating methodologies are continuous?

Article 5.1 A credit rating agency shall use credit rating methodologies that:

(a) ensure that credit ratings are responsive to changes in market conditions over time;

(b) continue to be used unless there is an objective reason for it to change or be discontinued; and

(c) are capable of promptly incorporating any finding from on-going monitoring or a review, in particular where changes in macroeconomic or financial market conditions would be capable of affecting credit ratings produced by that methodology.

We note that subparagraphs (a) and (c) refer to change, rather than continuity. They also duplicate the requirements of Article 3.4. Conceptually, we agree with ESMA that change should be seen in conjunction with continuity: where possible, gradual development is desirable to enhance the comparability of ratings over time. Gradual development will also reflect the fact that market structures typically develop in a gradual way. However, where a CRA has identified the need for more drastic changes, for example in response to a structural break, it should be able to implement these without any regulatory restriction in respect of "continuous" methodologies.

In respect of (a), we also note that a methodology in itself cannot "ensure" that ratings are responsive to changing market conditions, as ratings will reflect judgments reached by committees as well as changes to the methodology used.

Furthermore, ratings should reflect changes in structural conditions but not changes in current macroeconomic conditions, as ratings are designed to be valid through the cycle. Fundamentally, we therefore believe that the criterion of "continuous" should be read as requiring that one and the same methodology is applicable under a range of different macroeconomic and financial market conditions. This seems partly to be addressed by subparagraph (b).

We therefore suggest wording as follows:

Article 5.1 Without prejudice to Article 3.4, a ~~A~~ credit rating agency shall ~~use~~ design its credit rating methodologies in a way that allows for comparability of its ratings across different asset classes and throughout the economic cycle. ~~that:~~

~~(a) ensure that credit ratings are responsive to changes in market conditions over time;~~

~~(b) continue to be used unless there is an objective reason for it to change or be discontinued; and~~

~~(c) are capable of promptly incorporating any finding from on-going monitoring or a review, in particular where changes in macroeconomic or financial market conditions would be capable of affecting credit ratings produced by that methodology.~~

In respect of the criteria underlying subparagraphs (a) and (c), we suggest amending Article 3.4 as follows (building on the language proposed above, additions underlined):

Article 3.4 A credit rating agency shall make any changes to methodologies that it finds to be needed to reflect structural changes in market conditions. It shall have processes in place so that credit rating methodologies, in a timely manner, take account of findings from an internal review undertaken by its review function or any other relevant person or committee involved in the monitoring and reviewing of credit rating methodologies.

Subject to validation based on historical experience including back-testing

Question 4: Do you consider that these requirements would help ESMA in complying with its obligations set out in Article 22a?

Article 22a explicitly applies "without prejudice to Article 23", that is the principle of non-interference with the content of ratings or methodologies. We are concerned that this principle is undermined by Article 6.2. As noted in our general comments, the RTS should be designed to support the market in its judgement of CRAs' performance. This is as opposed to making ESMA the arbiter of the value of credit ratings, which might be inferred by the use of language such as require CRAs to "demonstrate" – presumably, to ESMA – the robustness and predictive power of its ratings.

In this context, we are also concerned that the proposed language would require us to implement an overly quantitative focus. Notably we do not believe statistical techniques to be relevant for the majority of our methodologies.

Article 6.1 A credit rating agency shall use credit ratings methodologies that rely on quantitative evidence of the discriminatory power of the methodology.

While we agree with the principle, we believe that greater clarity could be achieved through the following redrafting: "Credit rating methodologies shall be designed to allow the appropriate rank-ordering of credit risk linked to different issuers or financial instruments, in a way that clearly differentiates between different degrees of risk".

Article 6.2 A credit rating agency shall use credit rating methodologies based on statistical techniques that demonstrate:

(a) the robustness and predictive power of credit ratings over appropriate time horizons and across different asset classes; and

(b) the degree to which the default probabilities or expected losses predicted by the rating model match the actual default and loss rates.

As noted above, we believe that the judgement as to the "robustness and predictive power of credit ratings" should be taken by the market. The most effective tool to this effect is transparency, as is the objective of the central repository that will be maintained by ESMA pursuant to Article 11(2). Preferably, Article 6.2 should therefore be deleted altogether.

At a minimum, we suggest that the specification "based on statistical techniques" be deleted.

Article 6.3 The validation of a credit rating methodology shall be designed to:

(a) examine the sensitivity of a methodology to changes in any of its underlying assumptions, including qualitative or quantitative factors;

(b) perform an adequate and appropriate assessment of historic credit ratings produced by means of that credit rating methodology;

(c) use reliable inputs, including appropriate size of the data samples; and

(d) for each of the credit rating categories rated (such as structured finance, sovereign, corporates, financial institutions, insurances, public finance) take appropriate account of the main geographical areas of the rated entities or financial instruments.

The intention of subparagraph (a) seems to be to ensure that CRAs thoroughly consider the assumptions underlying their ratings. We do this by analysing rating performance. As opposed to this, we do not agree with the proposed requirement of "sensitivity analysis", for two reasons.

First, our methodologies are designed to support the analysis of credit risk in the circumstances as we see them. They contain some fundamental assumptions, but it would not seem meaningful to validate a methodology assuming that markets were fundamentally different from what we believe they are. Instead, the methodology should be reviewed where there are indications in respect of a shortcoming of the methodology.

Secondly, the proposed language reflects an overly quantitative perception of the rating process. As noted above, methodologies provide a comprehensive set of considerations about credit risk. Methodologies also set out how to make use of assumptions within a disciplined framework, but they generally do not quantify assumptions. This is different from a quantitative model, where adjustments made to one parameter will directly lead to a different set of results.

As regards subparagraph (c), we would concur that it is appropriate to require CRAs to consider the plausibility of the data they use. However, CRAs are not auditors and should not be required to verify the data in any other way. Furthermore, in respect of (b) and (c) it must be noted that availability of data will be limited in some circumstances, for example where methodologies have recently changed.

We understand that the underlying objective of the proposed provisions is that of ensuring an appropriate validation process for CRAs' methodologies, and suggest the following wording:

Article 6.3 CRAs should use techniques they deem appropriate, including statistical analysis where there are sufficient and relevant data, to validate that the ratings developed in the framework of its methodologies appropriately rank-order risk.

Article 6.4 A credit rating agency shall use credit rating methodologies that incorporate procedures designed to ensure that systemic credit rating anomalies highlighted by back-testing are identified and appropriately addressed.

We suggest drafting amendments to clarify that the procedures are not built into the methodology, but rather apply to the CRA more generally:

Article 6. 4. A credit rating agency shall have processes in place to ensure ~~use credit rating methodologies that incorporate procedures designed to ensure~~ that systemic credit rating anomalies highlighted by back-testing are identified and appropriately addressed.

Article 6.5 A credit rating methodology shall include:

(a) regular credit rating and performance reviews on rated entities and financial instruments;

(b) in-sample and out-of-sample testing; and

(c) historic information on validation or back-testing.

Reviews are not conducted by type of methodology: some methodologies apply just to a small number of ratings, which would severely restrict the meaning of an isolated review. On the other hand, some methodologies encompass multiple regions, for which it might be more appropriate to conduct separate rating performance reviews. In our view the objective should be to ensure that the results of the portfolio review are appropriately taken into account in the methodology review.

As regards subsection (a), we propose to align with the requirements of the Regulation. As regards subparagraph (b), we do not know what is meant by "in-sample and out-of-sample testing" and propose deletion.

We suggest amending as follows:

Article 6.5 In the process of reviewing a ~~A~~ credit rating methodology, the credit rating agency shall ~~include:~~ take account of the past performance of its

~~(a) regular~~ credit ratings ~~and performance reviews on rated entities and financial instruments;~~

~~(b) in-sample and out-of-sample testing; and~~

~~(c) historic information on validation or back-testing~~.

Question 5: Should other costs or benefits be considered when assessing the impact assessment of the draft RTS?

As a general consideration, we believe that an impact assessment is a broader concept than a cost-benefit-analysis. ESMA's assessment lacks a fundamental qualitative consideration as to how ESMA expects CRAs' working procedures and assessment processes to change as a result of the proposed RTS. This might be complemented with a consideration of how ratings are used in the market.

Indeed, we do not share ESMA's expectations as to the likely benefits of the proposed RTS, as currently drafted, to the market. Instead, as set out above we perceive a risk of regulatory interference with the substance of our methodologies and ratings. We are highly sceptical that this would lead to the greater accuracy of ratings. In particular, we do not believe that the market would be served by an increased use of quantitative models, as seems to be favoured by ESMA.

By contrast, regulatory interference might lead to rating agencies coalescing around one methodological approach. This in turn could create an impression of a single, right credit rating, which could lead to greater reliance on that rating. In our view, regulation should encourage rating agencies to hold differing views, and for market participants to view those ratings as just one more perspective in the broader analysis they conduct.