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| 17 November 2015 | ESMA/2015/1736 |

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| Reply form for the Discussion Paper on the validation and review of Credit Rating Agencies’ methodologies |
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| Date: 17 November 2015 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Discussion Paper on the validation and review of Credit Rating Agencies’ methodologies, published on the ESMA website.

*Instructions*

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

* use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
* do not remove the tags of type <ESMA\_ QUESTION\_VR\_CRA\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
* if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

* if they respond to the question stated;
* contain a clear rationale, including on any related costs and benefits; and
* describe any alternatives that ESMA should consider

**Naming protocol**

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA\_VR\_CRA\_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

E.g. if the respondent were ESMA, the name of the reply form would be:

ESMA\_VR\_CRA\_ESMA\_REPLYFORM or

ESMA\_VR\_CRA\_ESMA\_ANNEX1

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

***Deadline***

Responses must reach us by **19 February 2016.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings ‘Legal notice’ and ‘Data protection’.

# Introduction

Please make your introductory comments below, if any:

< ESMA\_COMMENT\_VR\_CRA\_1>

Dear Sir,

We welcome ESMAs Discussion Paper on the validation of CRA rating methodologies and the techniques proposed by ESMA. This Discussion Paper is based on ESMA’s review of current practices of CRAs, which shows that CRAs apply a wide-range of different techniques to a differing degree depending on the methodologies being validated. The diversity of approaches reflect the different market segments, scopes of the methodologies as well as analytical approaches and choices by the CRAs in defining relevant quantitative and qualitative rating criteria.

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| **Market Segment** | **Comment on size of market and default experiences** |
| Sovereigns | Around 200 Sovereigns are currently rated. The number of Sovereigns is limited and the default experiences equally. The IMF concluded in its Global financial Review dated October 2010, that CRAs managed to properly rank sovereign risks. |
| Sub-Sovereigns | The institutional set-up within a country on the relations between the top-level sovereign and its constituents varies substantially (as the degree to define and collect taxes of a Municipality depends on the country of residence). Default evidence is, for the vast majority of geographies, non-existing. |
| Covered Bonds | The legal regime on Covered Bonds varies across Europe – this market can’t be aggregated into a single market segment.Given the high regulatory framework on covered bonds already in place (eg double-recourse structure), historical default evidence is virtually non-existing. |
| Insurances | Given the regulatory regime on insurances, defaults are equally non-existant as supervisors would step-in earlier. |
| Banks | The regulatory regime on banks has substantially evolved in recent years.But, defaults by banks have historically remained low as often Sovereigns stepped-in.We note that BIS proposes that CRAs provide rating assessments excluding potential Sovereign support. While we note that some CRAs may exclude sovereign support already, we think that the principle of non-interference into a CRA’s methodologies as embedded in the EU CRA Regulation should prevail. |
| Global large non-financial issuers | The large global non-financial issuers together with the Stock listed companies correspond to a very limited share of the companies in a country. The number of ratings per geography (jurisdiction) is therefore limited.  |
| SME Ratings | Some CRAs provide a wide coverage of SME ratings in specific geographies. Given the high number of outstanding ratings, some statistical performance analysis could be done.  |
| Structured Finance | Taken at an aggregate level, this market segment would be suited for quantitative techniques.With reference to the Mapping of SF Ratings, we note that the performance of CRAs has substantially differed according to market segments and/or geographies. Disaggregating this market leads automatically to reduced number of ratings and number of defaults. |

Based on the above high-level analysis of the main market segments, we think that the vast majority of rating methodologies fall into the category of “Low Quantitative Evidence” – the benefits anticipated by ESMA for the “Sufficient quantitative evidence” cases will therefore be limited to very few cases.

Not surprisingly, during the Open Hearing held on January 25th in Paris on this topic, CRAs voiced concerns regarding the ability to run the proposed statistical tests (this argument being reflected in the Discussion Paper)

We understand that the proposed validation techniques should apply equally to new methodologies and to the revision of methodologies:

* by virtue of the CRA Regulation and the mandatory registration of a CRA before the issuance of a rating, with respect new CRAs (and new methodologies), historical evidence measured in terms of assigned ratings will always be 0
* with respect to the review of existing methodologies, this may go beyond the modification of quantitative (ratio driven) criteria and may introduce additional new factors (not considered earlier and therefore no data being collected on this aspect). By modifying a methodology, issued ratings base on a former methodology may be considered obsolete.

This Discussion Paper may lead to the issuance of a specific guidance to CRAs by ESMA, in line with the recent recommendation from the European Court of Auditors report on the EU Supervision of CRAs. Such guidance would be beneficial to CRAs in terms of outlining ESMAs expectations with regard to statistical methods, approaches, thresholds and potential further actions. We think that these options should be duly evaluated and considered by CRAs – but none of these can be made compulsory given the diversity of market segments covered by rating methodologies. Additionally, the list of proposed techniques should not be considered as exhaustive, as new techniques may be developed or other techniques may be used.

We remain at your full disposal for any clarification or further information.

Thomas Missong Adolfo Estevez Beneyto

EACRA President EACRA Secretary General

On behalf of the following ESMA registered and certified CRAs: AM Best, ARC Ratings, Assekurata, Axesor, Capital Intelligence, Cerved Rating Agency, Creditreform Rating, CRIF, Dagong Europe, Egan-Jones Ratings Company, Euler Hermes Rating, Kroll Bond Ratings and Scope Ratings.

< ESMA\_COMMENT\_VR\_CRA\_1>

1. Do you agree with ESMA’s view regarding the discriminatory power of methodologies?

<ESMA\_QUESTION\_VR\_CRA\_1>

We think that “the discriminatory power of a methodology relates to the ability to rank order the rated entities” creditworthiness using an established system of rating categories. A rating methodology may therefore not be based solely on defaults events.

As mentioned in our introduction, we think that the “sufficient quantitative evidence” case is rather the exemption than the rule.

With reference to §18 of the consultation, we note that ESMA considered that in some specific segment enough evidence was available to perform discriminatory tests, while one or more CRAs mentioned that this task was challenging. In case of such divergent views between ESMA and a CRA, we would welcome ESMA’s specific “technical advice” on how to address the quantitative evidence. The identified approach should be proportionate to the scope of the rating methodology as well as to the usage of CRAs by market participants.

<ESMA\_QUESTION\_VR\_CRA\_1>

1. Do you agree that the Accuracy Ratio, as derived from the CAP curve, is the minimum statistical measure that a CRA should use as part of its validation processes for demonstrating the discriminatory power of its methodologies?

<ESMA\_QUESTION\_VR\_CRA\_2>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_2>

1. Do you agree that complementary measures such as the Kolmogorov-Smirnov statistic and the ROC curve (along with a confusion matrix) add further information to the discriminatory power of methodologies? If not, please explain why.

<ESMA\_QUESTION\_VR\_CRA\_3>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_3>

1. Are there additional quantitative measures that CRAs should use and which would add further insight into the discriminatory power of methodologies? If yes, please explain the measures and your rationale.

<ESMA\_QUESTION\_VR\_CRA\_4>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_4>

1. Are there qualitative measures that are appropriate for demonstrating the discriminatory power of methodologies? If yes, please explain the measures and your rationale.

<ESMA\_QUESTION\_VR\_CRA\_5>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_5>

1. Do you agree with ESMA’s view regarding the predictive power of methodologies?

<ESMA\_QUESTION\_VR\_CRA\_6>

With reference to §41 of the Discussion Paper, we think that ratings are usually ordinal measures of credit-risk. The ordinal nature of ratings means that ratings are being ranked relative to each other and not against a pre-defined level of events (eg. Probability of default).

During the open hearing on January 25th, several CRAs mentioned that tying methodologies to specified levels of default may modify the nature of the rating product and may raise expectations from market participants regarding the specified levels.

With reference to §44 of the Discussion Paper, ESMA argues that tiding methodologies to creditworthiness-related expectations is based on the expectation of users of ratings and may feed into mapping of ECAI ratings. We instead think that ratings are a well established “product” known to financial market participants for several decades. We note that until recently the mappings were done on a highly pragmatic level: we note that the Capital Requirements Regulation (CRR) uses 6 credit quality steps under the Standardized Approach for Credit Risk and stress that the CRR itself does not define the probabilities of default associated with each credit quality step – only through the ITS on the mapping of ECAIs corporate ratings, such a correspondence table is being introduced. We think that the validation of a rating methodology should be separated from the mapping of ECAI ratings as these two exercises’ have different objectives and targets.

<ESMA\_QUESTION\_VR\_CRA\_6>

1. Do you agree that statistical measures of predictive power increase the quality of validation of CRAs methodologies and should be performed by the CRAs?

<ESMA\_QUESTION\_VR\_CRA\_7>

We think that such test should be applied only where a rating methodologies specifically targets probabilities of default.

<ESMA\_QUESTION\_VR\_CRA\_7>

1. Do you agree that the binomial and the chi-square tests are the minimum statistical measures that a CRA (when its ratings refer to default probabilities) should use as part of its validation processes for demonstrating the predictive power of its methodologies?

<ESMA\_QUESTION\_VR\_CRA\_8>

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<ESMA\_QUESTION\_VR\_CRA\_8>

1. Do you agree that complementary measures such as the Brier score and the Vasicek one-factor model test add further information to the predictive power of methodologies (when the CRAs’ ratings refer to default probabilities)? If not, please explain why.

<ESMA\_QUESTION\_VR\_CRA\_9>

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<ESMA\_QUESTION\_VR\_CRA\_9>

1. Are there additional measures that CRAs should use and which would add further insight into the predictive power of methodologies when the CRAs’ ratings refer to default probabilities? If yes, please explain the measures and your rationale.

<ESMA\_QUESTION\_VR\_CRA\_10>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_10>

1. Are there qualitative measures that are appropriate for demonstrating the predictive power of methodologies when the CRAs’ ratings refer to default probabilities? If yes, please explain the measures and your rationale.

<ESMA\_QUESTION\_VR\_CRA\_11>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_11>

1. Do you agree that CRAs using methodologies related to creditworthiness measures other than default probabilities should use statistical measures to demonstrate the predictive power of their methodologies? If yes, please state the potential creditworthiness measures that methodologies could relate to and the corresponding statistical measures as well as any appropriate qualitative measures.

<ESMA\_QUESTION\_VR\_CRA\_12>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_12>

1. If ESMA establishes that there is a need for further guidance to the industry, should this guidance also cover the demonstration of predictive power of methodologies related to creditworthiness measures other than default probabilities?

<ESMA\_QUESTION\_VR\_CRA\_13>

We welcome this Discussion Paper on the validation of rating methodologies as it shares ESMAs findings and outlines potential approaches. We think that this “catalogue” of approaches should be considered by CRAs in the process of the validation of rating methodologies. In view of the variety of market segments and the overall limited quantitative evidence, we think that the intended guidance should remain flexible in nature.

<ESMA\_QUESTION\_VR\_CRA\_13>

1. Do you agree with ESMA’s view regarding the historical robustness of methodologies?

<ESMA\_QUESTION\_VR\_CRA\_14>

We are of the opinion that historical robustness measures should be applied carefully when the rating portfolio has a lower number of observations - calculating transition matrixes on the basis of eg. 5 ratings don’t derive any meaningfull statistical information and may be misguiding.

<ESMA\_QUESTION\_VR\_CRA\_14>

1. Do you agree that stability statistical measures and the transition (migration) matrices are the minimum measures that a CRA should use as part of its validation processes for demonstrating the historical robustness of its methodologies?

<ESMA\_QUESTION\_VR\_CRA\_15>

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<ESMA\_QUESTION\_VR\_CRA\_15>

1. Do you agree that complementary measures such as distribution analysis, the univariate analysis of rating determinants and benchmarking add further information to the historical robustness of methodologies? If not, please explain why.

<ESMA\_QUESTION\_VR\_CRA\_16>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_16>

1. Are there additional measures (qualitative or quantitative) that CRAs should use and which would add further insight into the historical robustness of methodologies? If yes, please explain the measures and your rationale.

<ESMA\_QUESTION\_VR\_CRA\_17>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_17>

1. Do you agree with ESMA’s view regarding the validation of methodologies with limited quantitative evidence?

<ESMA\_QUESTION\_VR\_CRA\_18>

With reference to § 54 of the Discussion Paper, we agree with ESMA that CRAs should establish internal guidelines regarding the validation of rating methodologies and whether these should be done under Article 7 of the RTS on rating methodologies or rather under Article 8 of that RTS. Such internal guidelines could take into account a.o. the number of default observations.

<ESMA\_QUESTION\_VR\_CRA\_18>

1. Do you agree that CRAs should, as a first step, investigate data enhancement in validating methodologies with limited quantitative evidence?

<ESMA\_QUESTION\_VR\_CRA\_19>

While we welcome ESMAs suggestion regarding data enhancements, we think that the proposed approaches have all important limitations:

* Expanding the data sample with the use of third party data (eg ratings issued by another CRA) may not necessarily improve the information base of a CRA – ratings issued by another CRA are based on that CRAs methodology and need therefore to be validated by that CRA only.
* Combining asset classes to perform joint validation assessments, leaves out the specificities identified for each asset class.

Hypothetical transactions are by definition hypothetical and therefore equally subject to expert opinion. Additionally, creating hypothetical ratings on a large scale may be associated with very high administrative costs to the CRA

<ESMA\_QUESTION\_VR\_CRA\_19>

1. Do you agree that CRAs should, as a second step, investigate measures that may enable them to perform statistical tests to demonstrate the discriminatory power of their methodologies?

<ESMA\_QUESTION\_VR\_CRA\_20>

We welcome the additional measures proposed by ESMA but note again important limitations:

* The use of a relaxed “default definition” does not trigger more Defaults;
* Combining rating categories can be done only if the combination is made within rating categories with similar risk (e.g. notches).

<ESMA\_QUESTION\_VR\_CRA\_20>

1. Do you agree that historical robustness measures should be performed when validating methodologies with limited quantitative evidence?

<ESMA\_QUESTION\_VR\_CRA\_21>

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<ESMA\_QUESTION\_VR\_CRA\_21>

1. Do you agree that the transition (migration) matrices and benchmarking are the minimum measures that a CRA should use as part of its validation processes for methodologies with limited quantitative evidence?

<ESMA\_QUESTION\_VR\_CRA\_22>

With respect to the benchmarking of a CRA rating to ratings from other CRAs, we think that this exercise is interesting but should be done very carefully as each CRA uses its own rating methodologies and rating scales – benchmarking CRAs ratings to each other may create a self-referencing system and “outlayers” would be eliminated over time, leading to a harmonisation of rating methodologies across CRAs and thereby reducing information content of several ratings to users. In view of the performance of SF ratings during the global financial crisis, we recommend that each CRA is assessed at its own merits. Moreover, the rating portfolio of a new CRA does often not overlap with that of other existing CRAs.

With respect the benchmarking to credit default swaps spreads or bond yields, we note that these two measures take into account other factor than only creditworthiness – these may be driven amongst others by market liquidity.

<ESMA\_QUESTION\_VR\_CRA\_22>

1. Do you agree that complementary historical robustness measures add further information to the validation processes for methodologies with limited quantitative evidence? If not, please explain why.

<ESMA\_QUESTION\_VR\_CRA\_23>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_23>

1. Are there additional measures that CRAs should use when validating methodologies with limited quantitative evidence? If yes, please explain the measures and your rationale.

<ESMA\_QUESTION\_VR\_CRA\_24>

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<ESMA\_QUESTION\_VR\_CRA\_24>

1. Do you agree that thresholds should be set for the quantitative validation techniques?

<ESMA\_QUESTION\_VR\_CRA\_25>

We understand that the thresholds should relate to anomalies highlighted by back-testing. In view of the different distribution of ratings per market segment, anomalies will differ and can’t be harmonized across all market segments and CRAs. Quantitative thresholds may prove to be difficult to set and therefore expert judgment on qualitative factors should be an alternative approach.

<ESMA\_QUESTION\_VR\_CRA\_25>

1. Do you agree that the Internal Review Function should decide on these values?

<ESMA\_QUESTION\_VR\_CRA\_26>

We think that the threshold should be set according to each CRAs procedures for the establishment (or review) and approval of rating methodologies.

<ESMA\_QUESTION\_VR\_CRA\_26>

1. **Do you agree that predefined actions should be defined by the CRAs when the thresholds are met?**

<ESMA\_QUESTION\_VR\_CRA\_27>

“Predefined actions” could include a wide range of topics (such as further analysis of an identified topic) and may not necessarily lead to a change of a rating methodology.

<ESMA\_QUESTION\_VR\_CRA\_27>