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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>

We support the view that validation and review of CRA rating methodologies should be supported by quantitative evidence.

We believe that disclosure of the validation process performed by a CRA and its summarised results are as important as the process itself. To enhance transparency, CRAs should at minimum publicly disclose the validation process undertaken, the techniques used with brief justifications, in case quantitative techniques are not feasible the alternatives used and the reasons why, and summary results of the validation process per rating model. Moreover, CRAs should clearly disclose any revisions to their methodologies as a result of their validation process.

< ESMA\_COMMENT\_VR\_CRA\_1>

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

<ESMA\_QUESTION\_VR\_CRA\_1>

Yes. CRAs should demonstrate sufficiently that their methodologies result in a robust ranking of rated entities.

<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>

The Accuracy Ratio, as derived from the CAP curve, provides a basic check on the discriminatory power and should be a minimum requirement.

<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>

Yes, both the ROC curve and the Kolmogorov-Smirnov statistic serve as useful complementary measures of the discriminatory power of rating methodologies. However CRAs should be allowed to use alternatives provided that sufficient justification is given and disclosed.

<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>

In addition to the minimum requirement stated above, CRAs should be allowed to use other techniques with appropriate justification and disclosure to the market.

<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>

Yes. CRAs should be able to demonstrate that their ratings can be mapped to relatively narrow PD ranges which do not fluctuate significantly over time.

<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>

Yes. It is important for the users of external ratings to understand the volatility of the predictive power of rating agency models.

.<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<ESMA\_QUESTION\_VR\_CRA\_13>

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

<ESMA\_QUESTION\_VR\_CRA\_14>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

Yes.

<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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_VR\_CRA\_24>

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

<ESMA\_QUESTION\_VR\_CRA\_25>

Yes.

<ESMA\_QUESTION\_VR\_CRA\_25>

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

<ESMA\_QUESTION\_VR\_CRA\_26>

Yes.

<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>

Yes

<ESMA\_QUESTION\_VR\_CRA\_27>