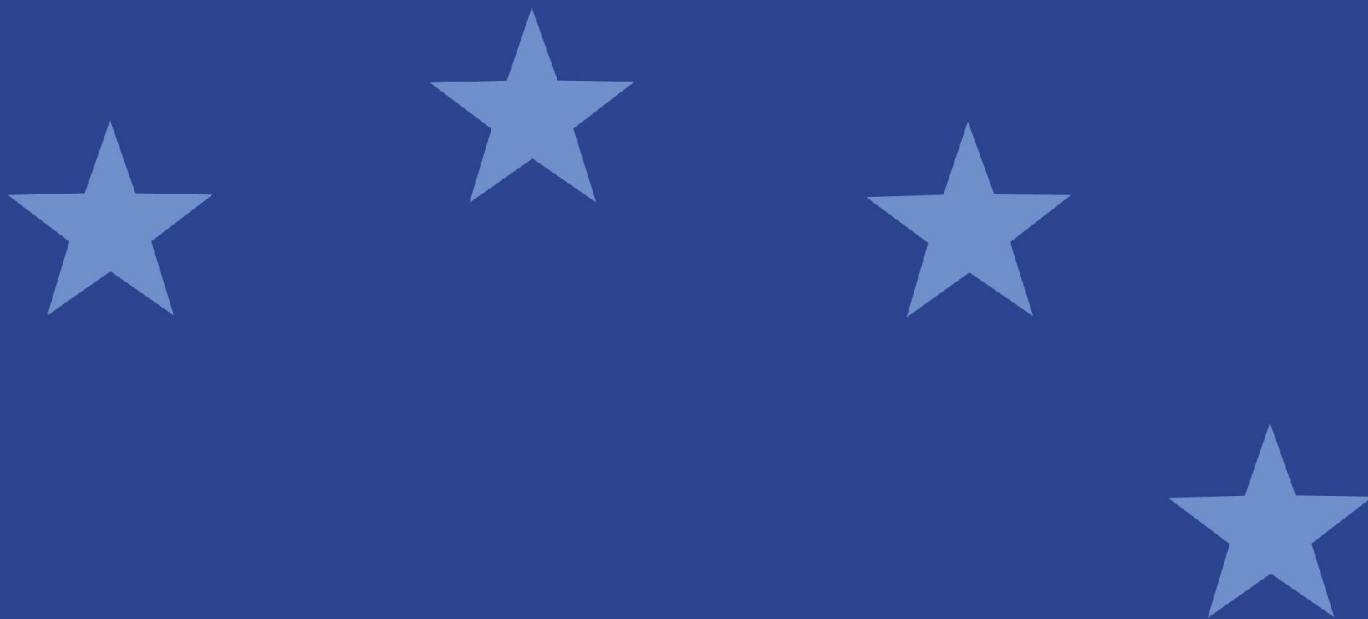




European Securities and
Markets Authority

Reply form for the Consultation Paper on Guidelines on validation and review of Credit Rating Agencies' methodologies



Responding to this paper

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

Instructions

Please note that, in order to facilitate the analysis of the responses, 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_CP_GCRA_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_CP_GCRA_NAMEOFCOMPANY_NAMEOFDOCUMENT.

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

ESMA_CP_GCRA_XXXX_REPLYFORM or

ESMA_CP_GCRA_XXXX_ANNEX1

Deadline

Responses must reach us by **22 August 2016**.

All contributions should be submitted online at 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 under the headings 'Legal notice' and 'Data protection'.



Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_CP_GCRA_1>

Dear Mr Flinterman,

We welcome the opportunity to comment on the guidelines on the validation and review of Credit Rating Agencies' methodologies, which ESMA published on 13 July 2016. We strongly support ESMA's view that guidelines on how CRAs comply with the requirements for credit rating methodologies will help to ensure the consistent application of validation and review measures for demonstrating the discriminatory power, predictive power and historical robustness of rating agencies' methodologies.

The ESM perspective draws on the experience of our direct interaction with rating agencies as well as our own research in the realm of sovereign and supranational ratings.

We hope that you will find these comments useful for the further development of ESMA's Guidelines on the validation and review of CRAs' methodologies.

Please do not hesitate to contact us should you require any further clarification.

Best regards,

Rolf Strauch
European Stability Mechanism
Member of the Management Board
Economics, Policy Strategy and Banking
<ESMA_COMMENT_CP_GCRA_1>

Q1: Has ESMA captured all related costs and benefits in its analysis under Annex II?

<ESMA_QUESTION_CP_GCRA_1>

ESMA has captured the most important costs and benefits validation processes and in particular the use of quantitative measures. In addition, we emphasize that the clarity provided by the Guidelines and the resulting improvement in the quality of the validation performed by CRAs, is likely to affect the quality of ratings also via greater competition among CRAs. This could be fostered, for instance, by publishing, at regular intervals, overviews on the quality of the validation and review for all agencies' methodologies. This would aid policymakers and market participants in assessing the quality and credibility among rating agencies.

<ESMA_QUESTION_CP_GCRA_1>

Q2: Do you agree that it is appropriate to set out certain measures as ones that ESMA "typically expects"? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_2>

Yes, we agree.

It would be beneficial if all agencies were to publish a comparable set of quantitative indicators/measures to demonstrate the discriminatory and predictive power as well as the historical robustness of their methodologies for all asset classes.

<ESMA_QUESTION_CP_GCRA_2>

Q3: Where a CRA diverges from measures ESMA typically expects to be used, do you agree that it should document its rationale and explain how it meets the regulatory requirements? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_3>

Yes, we agree.

This requirement would reduce the number of exceptions.

<ESMA_QUESTION_CP_GCRA_3>

Q4: Do you agree that where a CRA does not use the CAP curve, the ROC curve should be added as an alternative measure that ESMA should typically expect? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_4>

Yes, we agree.

For comparability purposes, it would also be beneficial to define for all agencies in advance the specific time horizon over which their methodologies should be able to rank order rated entities. In addition, we would welcome the publication of the distribution of observed default rates per rating grade and asset class.

<ESMA_QUESTION_CP_GCRA_4>

Q5: Do you agree that ESMA should include a reference to qualitative measures under potential complementary measures? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_5>

Yes, we agree that there is merit in including qualitative measures to assess the predictive power for credit ratings.

In addition, for ratings which refer to creditworthiness measures other than default probabilities, we would welcome comparable measures of predictive power so as to ensure that, irrespective of the precise rating definition, statistics on the predictive power of agencies' methodologies remain comparable. The rationale is that even if definitions of ratings vary across agencies, market participants and policymakers tend to view them interchangeably. It is thus important that comparable statistics exist despite slightly different rating definitions.

<ESMA_QUESTION_CP_GCRA_5>

Q6: Do you agree that the Population / System Stability Index is more appropriate as a complementary measure? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_6>

We believe that a very helpful measure to assess the historical robustness of methodologies, is the extent to which judgement is used to determine the final rating for an issuer or instrument. A recent ESM Working Paper¹ shows that comparing the methodology or model-implied rating to the actual observed rating over an extended time period, can provide valuable insights for assessing the signalling power of agencies' methodologies. A meaningful deviation between the two ratings could suggest that a methodology does not (yet) adequately incorporate all creditworthiness-related aspects. This complementary measure, which pre-supposes fully transparent methodologies, could be particularly helpful for asset classes which do not experience many defaults (such as sovereigns or supranational entities) as the assessment of the historical robustness of these methodologies is likely to be challenged by fewer statistically significant observations.

<ESMA_QUESTION_CP_GCRA_6>

Q7: Do you agree that where a CRA chooses to use data enhancement techniques it should be subject to verifying data quality and safeguarding the characteristics of the rated population, including its default rate? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_7>

Yes, we agree.

We understand that the validation of methodologies with limited quantitative evidence constitutes a challenge for CRAs, however, every effort ought to be undertaken to ensure their robustness.

<ESMA_QUESTION_CP_GCRA_7>

Q8: Do you agree that a CRA needs to adopt a consistent approach in setting thresholds for both qualitative and quantitative validation techniques? If not, please explain why.

<ESMA_QUESTION_CP_GCRA_8>

Yes, we agree.

Objective thresholds for the quantitative and qualitative validation techniques for each asset class would add to the objectivity of the validation process.

<ESMA_QUESTION_CP_GCRA_8>

¹ D'Agostino, A., Lennkh, R.A. 'Euro area sovereign ratings: An analysis of fundamental criteria and subjective judgement', ESM Working Paper Series, May 2016