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| 13 July 2016 |

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| Reply form for the  Consultation Paper on Guidelines on validation and review of Credit Rating Agencies’ methodologies |
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| Date: 13 July 2016 |

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](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\_CP\_GCRA\_1>

Fitch continues to be very concerned by the European Securities and Markets Authority’s (ESMA) proposed ‘Guidelines on the validation and review of Credit Rating Agencies’ methodologies’. Despite what we felt was healthy dialogue during the response period, the guidelines released still express expectations that CRAs will have to define default rate expectations for credit ratings to fully satisfy the predictiveness elements being introduced. This has significant potential to interfere with the content and methodology of ratings, and is not required by regulation.

The EU regulation defines a credit rating as ‘an opinion regarding the creditworthiness of an entity, a debt or financial obligation…’. Fitch’s ratings, like those of most other CRAs, express creditworthiness as a ‘relative rank order, which is to say [ratings] are ordinal measures of credit risk and are not predictive of a specific frequency of default or loss.’ This definition is permitted by law and is unchanged since Fitch registered with ESMA.

The terminology and expectations introduced are what continues to make the conclusions reached so difficult to understand and accept. For example, Fitch believes ESMA's goal of expanding data sets to create more knowledge and certainty about the markets and instruments being analysed is laudable. However, uncertainty is at the core of risk analysis. Rating decisions are forward-looking opinions about often very unlikely events. One of the causes of the structured finance crisis was that investors believed that sophisticated models could remove uncertainty. They cannot.

Expanding data sets can lead seasoned market professionals to draw false conclusions, by providing greater confidence about the outcome than is justified. Fitch's concern with the expansion of data is not the act itself but the strength of the conclusions the agency is expected to make upon data that is not directly relevant.

The Feedback Statement explicitly cites “ESMA has suggested that CRAs may establish expectations based on ranges per credit rating category…”. While some of these may be very broad and simply based on history, it may be the best solution, as we remain strongly resistant to using complicated statistical test/measures to overcome the limitations of small data sets. The financial crisis has shown what clever quantitative experts can do with such data sets that appear convincing and lead to risks that only history reveals as obvious after the fact. Pushing this type of exercise risks a return to a false expectation of precision, something Fitch seeks to protect against with its analytical judgement and experience.

**You Are What You Measure**

A key concern is that if the ESMA proposed guidelines are approved and Fitch has to measure the performance of our ratings against set default expectations then committees will start to change ratings based on those default expectations.

For the last 100 years, the focus of Fitch’s credit committees has been on peer analysis rather than default probabilities. For example, it is inconceivable to any Fitch analyst that a sovereign rating committee would assign – or even discuss – a specific default rate for any given sovereign. The subject of the committee is always the relative credit risk of the sovereign being analysed compared with other Fitch ratings. If Fitch introduces a default rate range that could lead to a criteria being rejected if ratings performance moves outside of the range, then it is only natural that committees will believe they are supposed to assign ratings that fall within that band. This would be a seismic change in Fitch’s rating methodology.

**Historical Performance Shows Significant Variability in Default Rates Through the Cycle**

The ordinal nature of Fitch’s scale results in default rates that vary through cycles with higher default rates in deteriorating credit environments. The magnitude of the acceptable differences in default rates, especially for low rated credits, means it would be unwise for an investor to rely on any ‘expected default rate’ or even a range of default rates imposed by ESMA against the will of Fitch and other CRAs.

For example, ‘B’ ratings ‘indicate that material default risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is vulnerable to deterioration in the business and economic environment.’ In periods where there is no deterioration in the business and economic environment default rates will be near zero because there is a margin of safety relative to the current environment. However, if there is a change in environment default rates will increase. The sectors most vulnerable to the deterioration in the business environment could hit one-year default levels of 20% without being out of line with Fitch’s definition.

**How Should Ratings Performance be Measured?**

Credit rating agencies’ methodologies are the cornerstone of high-quality ratings and rightly so, it is one of ESMA’s priorities to enhance the criteria validation process across the industry. Fitch agrees that ratings performance should be the primary measure by which to judge the performance of a methodology.

Fitch’s ratings are ordinal rankings and therefore measures around the discriminatory power of ratings should be enhanced. Fitch’s methodologies attempt to rank order creditworthiness and that ranking can, and should, be quantifiably tested in a more uniform way across the industry. Fitch fully supports ESMA’s initiative on establishing the Accuracy Ratio as the minimum standard. In fact, subject to minimum size thresholds, Fitch would go further and make this measure public because it is a direct measure of the performance of ratings as defined by Fitch and used by the market.

**Conclusion**

Given the potential impact of ESMA’s proposed guidelines on Fitch’s credit rating product, it seemed important to restate our position. Despite multiple attempts to highlight the ratings realties and challenge of validating predictiveness, ESMA has developed a view that can lead to activity and behaviour that reintroduces expectations that are at best difficult to fulfil for our ratings given the ordinal nature we have been clear users should expect.

< ESMA\_COMMENT\_CP\_GCRA\_1>

1. Has ESMA captured all related costs and benefits in its analysis under Annex II?

<ESMA\_QUESTION\_CP\_GCRA\_1>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_1>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_2>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_3>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_4>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_5>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_6>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_7>

1. 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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_GCRA\_8>