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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>

TYPE YOUR TEXT HERE

< 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>

Even though the ongoing costs of implementing these tests after a period of 4-5 years’ work after accreditation (assuming this is enough time to have sufficient data to run the statistical tests) for small and young credit rating agencies would be bearable, the one-off cost would be rather high. First of all, an agency with insufficient quantitative evidence would need to gather the enhanced data from public sources, and even this does not guarantee gathering sufficient data to run the analytical models and the statistical tests (most of the models require substantial non-public information). Secondly, these data would need to be run many times through the analytical models in order to have enough scoring samples and defaults so the tests would be significant. With the established infrastructure of a compact agency, the marginal cost of performing this one-off activity requires a substantial workforce and a significant amount of time.

<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>

We agree that there should be certain suggested measures in place in order to validate a methodology. However, after going through the “typically” expected measures we concluded that, when data enhancement is not feasible, many rating assessments and defaults need to happen in order to be able to demonstrate the discriminatory power. The suggested CAP and ROC measures can only be performed with high amount of data and a minimum number of defaults in order for the tests to be relevant.

<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>

Yes. Since small and young credit rating agencies don’t have enough data to perform the aforementioned tests and data enhancing is difficult to achieve for several methodologies given the non-public status of the information needed to test and the amount of qualitative factors required in the models, other methods shall be developed by the agencies and should be documented (e.g. stochastic sensitivity analyses).

<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>

From both measures one can derive the accuracy ratio, thus, the CRA can be given the liberty to decide which one to use. In the Feedback Statement ESMA acknowledges the challenge of demonstrating discriminatory power in low probability of default methodologies or credit rating methodologies with limited quantitative evidence. In the proposed guidelines, ESMA provides some measures which CRAs may consider when assessing discriminatory power in these circumstances. However, we didn’t find any guidance in the Proposed Guidelines which CRAs may consider when assessing discriminatory power of “low probability of default methodologies” with statistical tests. The low default rate of sovereign makes it impossible to use the CAP curve and the ROC curve. We think that creating transition matrices and benchmarking should be enough to validate low probability of default methodologies.

<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>

Yes. However, the CRA should be free to decide which qualitative measure to use even if it is not included in the list.

<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>

Yes. We think transition matrices should be the minimum requirement as they are not difficult to interpret, easy to build and from them it is also simple to derive further tests. However, the stability index is a very good test to perform in case we want to know how the population has changed over time and it is useful to make adjustments if the environment has drastically transformed.

<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>

Yes. However, first of all, data enhancement techniques are almost solely applicable to entities for which the data is publicly available and assuming this data would be enough to run the analytical model. In order to test other methodologies for which publicly available data is not enough to run the models, one cannot use data enhancement as the majority of indicators used in our analytical models take into account non-public data.

Secondly, even if data enhancement is possible, the analytical models are also based on qualitative information. This qualitative information needs to be fed to the model as well as the quantitative data. Thus, by using historical data (data enhancement) the qualitative information input into the models will be biased towards macroeconomic and entity-specific events which already took place creating an artificial validation at the end.

<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>

For quantitative validation, yes. One needs to keep in mind, however, that measures of discriminatory power vary greatly over time. So one might have one threshold that triggers an in-depth analysis of anomalies and another threshold that is exceeded repeatedly, in order to revise the rating methodology.

Nonetheless, it is complicated to establish thresholds for qualitative techniques. For qualitative techniques it would be better to establish well-defined processes and guidance as to recognize different types of performances.

<ESMA\_QUESTION\_CP\_GCRA\_8>