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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>

Kroll Bond Rating Agency (KBRA) appreciates the opportunity to respond to ESMA’s Consultation Paper on Guidelines on validation and review of Credit Rating Agencies’ methodologies. KBRA is of the opinion that validation and review of our methodologies are critical components of our business, and we welcome the guidance provided by ESMA. Further, KBRA appreciates the flexibility that has been given to CRAs as a result of the initial responses to the Proposed Guidelines.

While ESMA states it does not intend to “exclude the benefits brought to the validation process from the use of qualitative measures and expert judgment applied by staff”, KBRA notes that overreliance on certain quantitative measures stated in the Proposed Guidelines may indeed have that effect. KBRA is hopeful that ESMA continues to recognize, per Paragraph 10 of the Proposed Guidelines, the importance of expert judgment.

KBRA is pleased to provide our answers below to the eight questions posed in the latest request for response.

< 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>

The qualitative nature of the cost benefit analysis makes it difficult to assess its completeness. However, KBRA believes that the Proposed Guidelines will create costs beyond those embedded in Level 1 and Level 2 legislation. It seems likely that KBRA will incur additional cost beyond the “additional resource in the CRAs Review Functions and … training costs for staff. “ There may be additional resources required in the analytical staff, and it is likely that there will be IT and data infrastructure costs created by these requirements. Further, there may be additional 3rd-party data costs due to the proposed requirements regarding cases where KBRA chooses to use data enhancement techniques.

<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>

KBRA is generally more comfortable with the change from “measures that a CRA should use” to “measures that ESMA typically expects a CRA to use”. However, despite the change in nomenclature, KBRA still believes there is a risk that these measures will be elevated to *de facto* standard measures, which could potentially yield unintended consequences.

Additionally, KBRA would appreciate more guidance from ESMA on the measures that can be considered complementary measures.

<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>

KBRA is in agreement that divergence from the measures that ESMA typically expects to use should be documented, including a rationale and an explanation of how what is being provided meets the regulatory requirement. KBRA would appreciate guidance on ESMA’s criteria for determining how a measure that is not typically expected meets the regulatory requirements.

<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>

Since these two curves are essentially the same, CRAs should have the ability to provide either a CAP curve or a ROC curve, whichever they are most comfortable providing.

KBRA would like to take the opportunity to point out that these measures may be impossible to compute or unreliable for sectors which have limited coverage or low- or no-default experience.

<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>

KBRA agrees that ESMA should include a reference to qualitative measures under potential complementary measures. Further, KBRA notes that the context of this question is “for credit ratings which refer to default probabilities”. KBRA believes that CRAs should also have the ability to include qualitative measures as complementary measures for credit ratings that refer to creditworthiness measures other than default probabilities. <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>

KBRA agrees that the Population / System Stability Index is more appropriate as a complementary measure than a typically expected measure.

<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>

KBRA believes that data enhancement techniques, which can be effective in certain situations where data is lacking, have limitations. KBRA would appreciate guidance on the term “safeguarding” as it is used in this regulation and how ESMA intends to evaluate whether characteristics of the rated population have been sufficiently “safeguarded”. While CRAs should strive to enhance data sets with data that is representative of the rated population, in practice it can be difficult to get data proxies that are perfectly representative.

<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>

Since these thresholds are difficult to arrive at, CRAs should have the ability to use a threshold setting approach that is appropriate, even if it is not necessarily consistent between quantitative and qualitative techniques. It is difficult to compare qualitative and quantitative approaches, and overlaying a quantitative approach to expert judgment would not be feasible or practical. A variety of approaches for threshold setting should be allowed, provided that sufficient justification and documentation are presented.

<ESMA\_QUESTION\_CP\_GCRA\_8>