COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 30 August 2010
Ref.: CESR/10-945

GUIDANCE

CESR's Guidance on common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8.3

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I. INTRODUCTION

Background

1. The EU Regulation of the European Parliament and Council on Credit Rating Agencies (CRAs) was published in the Official Journal[1] on 17 November 2009 and came into force on 7 December 2009. As a result, CRAs operating in the EU will need to apply for registration between 7 June 2010 and 7 September 2010 for their ratings to be used for regulatory purposes in the European Community.

2. According to Article 21.3 (b) of the Regulation, CESR shall issue guidelines by 7 September 2010 on common standards for assessing compliance of credit rating methodologies with the requirements set out in Article 8.3.

3. This document deals with the guidelines CESR is required to produce, in accordance with the above-mentioned Article.

4. CESR consulted publicly on this Guidance between 17 May 2010 and 18 June 2010 to seek comments from the industry. Non-confidential responses to this consultation have been published on the CESR website (http://www.cesr-eu.org/index.php?page=responses&id=165). Having considered all feedback, CESR is publishing its final Guidance.

II. GUIDANCE ON RATING METHODOLOGIES

1. General remarks

5. Article 8.3 of the Regulation provides that "a credit rating agency should use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing".

6. This Guidance sets out the typical information that competent authorities would expect to receive for ongoing supervision of the registered CRA in order to assess its compliance with the provisions concerning credit rating methodologies as per Article 8.3 of the Regulation. The information contained herein should be provided to competent authorities[2] within one month after registration and on an ongoing basis when material changes to the information already submitted occur. An applicant should provide a clear explanation for not submitting any specific information contained herein.

7. The CRA is responsible for demonstrating compliance with the requirements of the Regulation on an ongoing basis. Should a CRA believe that additional information would materially affect the assessment of compliance of credit rating methodologies with the Regulation, such additional information should be submitted.

8. It is important to note that this guidance is not exhaustive. Whilst it provides base guidance, it does not prohibit further information requests where competent authorities deem necessary in order to discharge their supervisory or cooperation responsibilities under the Regulation.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF
[2] This information should be also sent to CESR in order to allow it appropriate record keeping and to facilitate the possible future changes mentioned in paragraph 12 below.

9. Whilst requests for information should be made in a written format to the extent possible, competent authorities may also make verbal requests where necessary. Requests for information should state the specific timeframe within which the CRA needs to respond.

10. The information submitted to the competent authorities will only be used by competent authorities solely to discharge their supervisory and cooperation responsibilities as defined in the Regulation and shall remain confidential unless otherwise provided by the Regulation.

11. Within this Guidance, a material change is any change that may affect the substance of the information already submitted to competent authorities. All changes that may affect compliance with the requirements of the Regulation are material. Material changes to a methodology include those related to a major departure from the current approach as well as those that have a material impact on ratings. Data and information on material changes shall be provided to competent authorities immediately.

12. It is important to note that this Guidance may be altered to reflect the possible change in supervisory responsibility to the European Securities and Markets Authority (ESMA).

2. Scope of the guidance

13. CESR understands the purpose of Article 8.3 is to ensure that CRAs' methodologies are developed, utilized and reviewed in such a way as to produce a well informed and well founded opinion on the credit worthiness of a rated entity and/or financial instrument. This guidance therefore sets out the steps that will be taken by competent authorities to monitor CRAs compliance with this Article.

14. Credit rating methodologies refer to criteria, models, methodological principles for a particular rating or practice; principles and fundamental elements used in analyzing credit risk; rating factors; qualitative or quantitative assumptions used to arrive at a rating opinion (e.g. analytical adjustments to financial statement information, stress scenarios and loss curves used for projecting future losses on asset pools).

15. After registration, CRAs must notify competent authorities of any material change in their rating methodologies (either global or on a specific asset class) and related analytical documentation including rating factors, criteria and/or parametric assumptions where relevant (e.g. basic scenario, correlation, probability of default, loss given default, expected/unexpected loss, loss curve, expected recovery rates, loss severity, etc, where appropriate).

16. Competent authorities will use the information requested herein to ensure that appropriate policies, procedures and controls are in place to fulfil Article 8.3 of the Regulation. No competent authority should be seen as validating any particular type of methodology or interfering with its content.

3. General information

<u>The CRA should submit the following information</u>:

17. Written policies and procedures ensuring on an ongoing basis that credit rating methodologies are rigorous, systematic, continuous and subject to appropriate validation.

18. Detailed description of the process for developing and reviewing methodologies and how methodologies are used in the main stages of the rating process. This description should

include detail on the interaction between analysts developing methodologies and staff involved in the actual rating of the securities concerned as well as the sign-off process.

19. Detailed description of how methodologies are implemented including a description of the processes in place to ensure consistency of approach in applying rating methodologies to credit ratings. In particular the role of rating committees and senior management should be elaborated.

4. Detailed information

A. Demonstrating credit rating methodologies are rigorous

CRAs have appropriate means, high standards and rigorous processes for developing, publishing, reviewing and using credit rating methodologies. with appropriate and sufficient knowledgeable and experienced resources dedicated to this activity.

<u>The CRA must demonstrate the following</u>:

20. They have appropriate controls in place for monitoring the input of staff responsible for approving, issuing or monitoring ratings into the development and updating of rating methodologies.

21. The methodologies are developed and elaborated so that they take into account all information available to the CRA and relevant to its analysis.

22. The review function is managed by a credit risk officer, or a person with similar responsibilities, with sufficient knowledge, experience and the relevant background to understand the complexities of rating methodologies. Such function is deemed to review methodology development & update as well as the staff that develops them. However, CRAs are expected to have controls in place to ensure that the methodologies are used and applied appropriately.

23. The development and review of the credit rating methodologies is performed with appropriate access to the information required to acquire a clear understanding of all factors relevant to the credit rating methodology, including its purpose. The review of credit rating methodologies should incorporate an analysis of the performance of ratings utilizing the methodology.

24. Suitable measures have been taken so that any information or data used for the purpose of developing and reviewing credit rating methodologies is from reliable sources and sufficient quality.

25. Methodologies are developed and reviewed by staff with appropriate qualifications and/or appropriate experience and expertise. Also there should be sufficient resources dedicated to these activities.

26. Methodologies are developed and reviewed via a clear process that allows for suitable challenge and there are sign-off procedures that are robust. There are appropriate procedures for discontinuing the use of methodologies.

<u>The CRA should submit the following information</u>:

27. Written policies about the specific task of the independent directors of the administrative or supervisory board on the monitoring of methodology development and reviews.

28. Written procedures in place to review and update rating methodologies. This may also include a general guide to their rating methodologies.

29. For each asset type, a description of the approach for determining and assigning importance to qualitative or quantitative factors within the methodology (including related weightings, where such weightings exist, and their respective impact on final ratings).

30. For each asset type and where relevant, a high level description of qualitative inputs, including the scope of qualitative judgment (e.g. regarding strategy, business plans of the rated entities, etc.).

31. Written procedures on how the CRA assesses if it has sufficiently reliable data to provide a credible credit rating or if it is the case to refrain from issuing a rating or to withdraw an existing rating.

32. For each asset type, a high level description of quantitative inputs including key variables, data sources, assumptions and quantitative techniques used, and the extent of input from rated entities, etc.

33. Details of how the frequency of the rating and performance reviews on rated issuers/transactions are linked to the revision of credit rating methodologies, related criteria and assumptions.

34. For each asset type, a description of the interrelationship between macroeconomic data and its impacts on the credit rating methodologies key assumptions.

35. For each asset type, a description of the interrelationship between the assumptions/criteria of a credit rating methodology and the volatility of ratings over time.

36. Information to demonstrate, through self-certification and appropriate proof (e.g. information on academic background and technical trainings received), that members of the rating teams and committees have the appropriate and required skills –including quantitative expertise and experience in issuing credit ratings–, and that these skills are improved over time through adequate training programs.

37. General information on rating reviews: e.g. the process in place, main characteristics, scope, frequency, people/teams involved, means used, treatment, main phases of the monitoring process, data updates, information from rated entities taken into account, automatic warning systems, mechanisms that allow systematic errors in issuance of credit ratings to feedback into potential changes in ratings methodologies, etc.

38. Details of written procedures ensuring an ongoing consistency between the insights/comments given by rating surveillance or monitoring of rated entities and or financial instrument and through them, their impact on the parameters and assumptions employed in the credit methodology.

39. Quantitative evidence of the discriminatory power of the credit assessment methodology using statistical techniques, comparing for example actual defaults with probabilities of default set out in the transition matrices, to demonstrate the robustness and predictive power of credit assessment over time and across different asset classes.

40. The process to request and obtain information from the rated entities, including the policy for gathering information from senior management of the rated entities (this latter information is to be provided upon request of the competent authority).

41. Detailed written procedures and policies to analyze the impact of changes to methodologies, publicize any change in the CRA's methodologies and potentially allow a period for public comment to the CRA, prior implementing these changes.

B. Demonstrating credit rating methodologies are systematic

Credit rating methodologies are developed and reviewed in a consistent, organized and repeatable manner. Similar methodologies are developed to rate similar financial instruments or entities and assumptions and macro-economic outlooks are applied consistently across methodologies.

<u>The CRA must demonstrate the following</u>:

42. They have procedures so that pre-defined methodologies are applied consistently in the formulation of ratings in a given asset class, or appropriate records of the reasons why a rating has diverged from the pre-defined methodology are kept.

43. There are procedures in place so that models, assumptions, inputs, macro-economic outlooks, etc are, to the extent possible, applied consistently across methodologies.

44. They have appropriate policies and procedures for reviewing situations when ratings diverge from the pre-defined methodology.

45. Ratings related to a methodology are subject to appropriate review when the methodology is amended.

<u>The CRA should submit the following information:</u>

46. A description of the procedures used to assess the consistent application of methodologies including details on the results and conclusions generated by such analysis. This should include the process for reviewing outstanding ratings when underlying methodologies are amended and details on specific cases when this has occurred.

47. Details of how the CRA ensures that assumptions, models, macro-economic predictions/outlooks, etc are applied consistently in the development and review of methodologies.

48. Policies and procedures for reviewing situations when ratings diverge from the pre-defined methodology to ensure there are appropriate reasons.

49. Written procedures for promoting a consistent approach to applying a methodology across the different ratings covered by it.

C. Demonstrating credit rating methodologies are continuous

Methodologies are appropriately monitored, reviewed, updated and responsive to market changes over time.

<u>The CRA must demonstrate the following</u>:

50. Rating methodologies should remain globally consistent and appropriate over time unless there is a robust reason for not treating a methodology consistently (in which case such reason should be provided).

51. Rating methodologies are updated as necessary and reviewed by employees who possess the necessary up to date know how, quantitative skills and experience. Where the review indicates that a potential change may be appropriate, such a change is appropriately considered.

52. The level of staffing and resources ensuring the continuity of the credit rating methodologies is appropriate, including for the effective and timely review of rating methodologies.

<u>The CRA should submit the following information</u>:

53. A detailed written continuity plan, relative to the scale and complexity of the business conducted, to cope with loss of key staff or any business disruption.

54. Information on the monitoring process and workplan to assess the performance of the methodologies employed.

55. Details of the process by which monitoring of methodologies would lead to the review process being initiated and summary of the outcome of such review.

56. Written procedures and policies concerning decisions to amend, withdraw or suspend a rating methodology and associated ratings.

57. Written procedures and information to ensure that the resources devoted to the monitoring of rating methodologies are appropriate in terms of know–how, analytical skills and quantity.

58. Written procedures and documentation, test plans and test scenarios as well as other procedures for addressing unforeseen events to allow for the ongoing assessment of rating methodologies.

D. Demonstrating credit rating methodologies are subject to validation based on historical experience, including back-testing

Methodologies and underlying assumptions are consistently reviewed against actual performance, new data and changes to underlying macroeconomic assumptions. There is a comprehensive and integrated process composed of back testing and establishing a rating validation framework to provide for clear, consistent validations of all the outstanding credit rating methodologies, while minimizing potential conflicts that may arise in these processes.

<u>The CRA must demonstrate the following</u>:

59. They have well-documented back-testing and rating validation policies and procedures that they adhere to.

60. They have a governance mechanism naming the ultimate responsibility for establishing and reviewing compliance with the back-testing and rating validation policies.

61. They have sufficiently knowledgeable and independent employees that are responsible for the back-testing and rating validation/ implementation, relative to the scale and complexity of the business conducted. Such employees, supported by adequate resources, should be separate from and do not report to the lead analysts and/or rating analysts.

62. When conducting back testing and rating validation, the CRA assesses the vulnerability of the credit rating methodology to various events and consistent tests are used to capture both macroeconomic and market events.

63. The frequency of back testing tests depends on the nature of the credit rating methodology and the assets covered, the specific risk to which it is exposed and changes in market conditions, among other factors.

64. They conduct their own relevance and reliability tests on the robustness of their methodologies and assumptions, for example in the case of default, recovery rates and correlations.

65. The validation process covers the quality of the inputs (including appropriate size of data sample) fed into the system and the reliability of the methods used to process them. The goal of these tests is to assess the quality of the credit ratings and processes being employed internally or by third-party service provider.

66. CRAs review their methodologies at least annually and after any material changes in macroeconomic or financial market conditions.

67. They have installed procedures to ensure that systematic rating errors highlighted by back testing and surveillance of credit ratings will be incorporated into rating methodologies and corrected.

68. They have appropriate mechanisms for assessing the performance of ratings against transition matrices.

The CRA should submit the following information:

69. Written policies and procedures describing the content of the validation process and in particular how this activity is related to possible changes of methodologies, for each asset type.

70. Written policies and procedures allowing a truly representative sample used to control accuracy of methodology.

71. Written policies and procedures stressing the relevant importance of in-sample and out-of-sample tests.

72. Details of the methods employed by the CRAs in their quantitative and qualitative assessments to confirm robustness, discriminatory power, and consistency of their ratings over time and across different market segments, including details on the results and conclusions generated by such analysis.

73. Historic information on validation and back-testing of methodologies and models. Such information should be provided for the past three years where quantitative data is available.