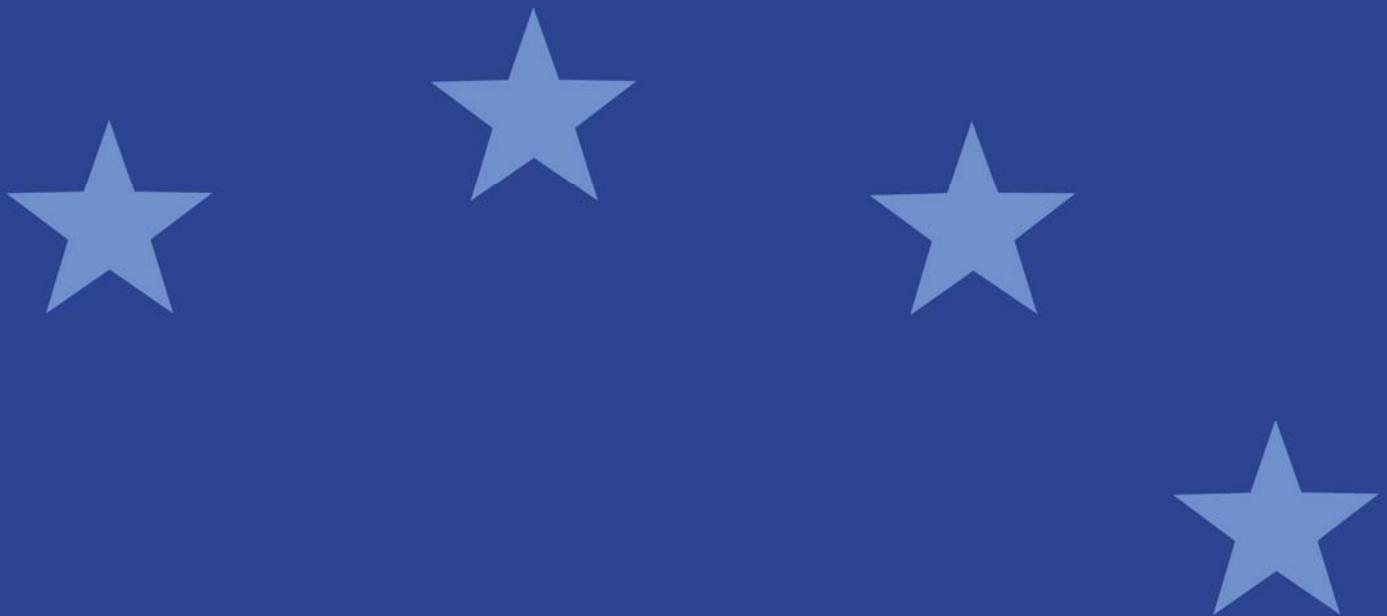




European Securities and
Markets Authority

Consultation Paper

Regulatory technical standards on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009



Responding to this Consultation Paper

European Securities and Markets Authority (ESMA) invites comments on all matters in this paper and in particular on the draft regulatory technical standards set out in Annex 1. Comments are most helpful if they:

- (a) indicate the specific question to which the comment relates;
- (b) respond to the question stated;
- (c) contain a clear rationale; and
- (d) describe any alternatives ESMA should consider.

ESMA will consider all comments received by the 21 October 2011.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. 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 not to disclose the response 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 heading 'Disclaimer'.

Who should read this Consultation Paper

The compliance with credit rating methodologies presented in this Consultation Paper is addressed to credit rating agencies, which are strongly recommended to assess the proposals and to provide input on the subject. Users of credit ratings and anybody who is wishing to learn about the rating methodologies may also find interesting to read this paper. This could comprise issuers, institutional investors, supervisory bodies but also academics.

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Executive Summary

Reasons for publication

1. Article 21(4) of Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies (**EU Regulation**) requires ESMA to develop draft regulatory technical standards on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of the EU Regulation.
2. Article 10 of the ESMA Regulation (EU) No 1095/2010 requires ESMA to “conduct open public consultations on draft regulatory technical standards and analyse the potential related costs and benefits.”
3. Article 21 (7) of the EU Regulation commits ESMA to cooperate with EBA and EIOPA in performing its tasks and shall consult them before submitting these standards to the Commission for endorsement in accordance with Article 10 of Regulation (EU) No 1095/2010 by 2 January 2012.
4. Accordingly, this Consultation Paper presents ESMA’s proposed development of Article 8(3) of the EU Regulation in accordance with that mandate. The public and market participants are asked to provide comments by the 21 October 2011. Comments are particularly welcomed on the content of the attached Annex I and the attached Impact Assessment in Annex II.

Next steps

5. ESMA will consider the feedback received on this consultation in October 2011 so that it is able to submit final regulatory technical standards for endorsement by the Commission by 2 January 2012.
-

I. Background

7. Article 8 (3) of the EU Regulation provides:

“A credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.”

8. In August 2010, CESR issued its “Guidance on common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3)” (CESR/Ref. 10-945), as required by Article 21(3) of the Regulation adopted in September 2009. The attached draft Regulatory Technical Standards draws closely on this Guidance but taking into account the changes generated as a result of the revision of the EU Regulation in terms of the mandatory level of the RTS as compared to the CESR Guidance.

9. Subsequently, the EU Parliament and the Council adopted the amending EU Regulation in December 2010, published on 11 May 2011, in order to transfer full responsibility for the supervision and enforcement of CRAs in the EU to ESMA from 1 July 2011.
10. The EU Regulation tasked ESMA through Article 21(4) (d) with the development of draft regulatory technical standards (RTS) on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3). In accordance with Regulation (EU) No 1095/2010, this draft RTS should be endorsed by the Commission to give them binding legal effect.
11. ESMA issued a Call for Evidence on 26 May 2011 to gather information from the public and market participants on the impact that the CESR guidance has had, including the costs implications if the standards embodied in it were made into RTS. ESMA also sought views on what should be included in the RTS. The Call for Evidence was open for response until 20 June 2011.
12. Taking account of the evidence it has received, ESMA is now consulting on its proposed draft of the RTS. Following consideration of responses received to this consultation, ESMA will develop a final draft to be sent to the Commission by 2 January 2012 for the Commission's endorsement. Subject to the outcome of the endorsement process, those standards will replace the previous guidance published by CESR.

II. The assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3)

13. The EU Regulation provides specific conditions and prerequisites under which a CRA shall use a credit rating methodology that is "*rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.*" This is designed to ensure the predictive power of the credit rating methodology.
14. Amongst other objectives, the requirements set out in Article 8(3) ensure that credit rating methodologies, models and key rating assumptions such as mathematical or correlation assumptions used for determining credit ratings are properly maintained, up-to-date and subject to a comprehensive review on a periodic basis and that their descriptions are published in a manner permitting comprehensive review.
15. This draft RTS is designed to ensure that credit rating methodologies reflect relevant development of the credit quality of a rated entity or financial instrument in an effective and timely way. This draft RTS is also designed to prevent instability and unreasonably frequent changes in the content of the credit rating methodologies that could be destabilising for rated entities, investors and financial institutions, particularly where significant portfolio revisions or dramatic changes in capital requirements are required as a result of those changes.
16. This draft RTS shall set out the requirements for the assessment of procedures adopted by CRAs in compliance with the requirements in Article 8(3) and in particular for the regular review of whether credit rating methodologies used by CRAs properly reflect changing markets conditions with a view to ensuring transparency and disclosure of any material modification to the methodologies and related practices, procedures and processes.

17. Without prejudice to Article 23 which prevents ESMA from interfering with the content of credit rating methodologies, ESMA notes that Article 22a of the EU Regulation compels ESMA to examine the compliance with the back testing obligation in the exercise of its ongoing supervision of CRAs with the requirements of Article 8(3). In particular ESMA shall:
 - a. verify the execution of back-testing by CRAs;
 - b. analyse the results of back-testing; and
 - c. verify that CRAs have processes in place to take into account the results of the back testing in their rating methodologies.
18. ESMA requests comments on this consultation paper; in particular, the RTS provided in Annex I and the Impact Assessment provided in Annex II.
19. It is also seeking specific feedback on the requirements for assessing whether credit rating methodologies are:
 - a. rigorous;
 - b. systematic;
 - c. continuous; and
 - d. subject to validation based on historical experience.

Questions:

Please comment on the content of the draft RTS attached to this consultation paper (Annex I) on the assessment of the compliance with the requirements of Article 8(3). Please also consider the attached Impact Assessment (Annex II). In particular, please consider:

>Rigorous

Question 1: Do you agree with the list of requirements set out in the attached draft RTS to assess whether a credit rating methodology is rigorous?

>Systematic

Question 2: Are there any other requirements that should be considered in the assessment of whether credit rating methodologies are systematically applied?

>Continuous

Question 3: Do you agree with the list of requirements set out in Article 5 defining whether credit rating methodologies are continuous?

>Back-testing

Question 4: Do you consider that these requirements would help ESMA in complying with its obligations set out in Article 22a?

>Impact assessment

Question 5: Should other costs or benefits be considered when assessing the impact assessment of the draft RTS?

Annex I

**[DRAFT] COMMISSION DELEGATED REGULATION (EU) No .../..
Supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the
Council of 16 September 2009 on credit rating agencies by laying down regulatory technical
standards for the assessment of compliance of credit rating methodologies**

Of xx xxxx 2011

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, and in particular Article 21(4)(d) thereof,

Whereas:

- (1) Regulation (EU) No 513/2011 provides the European Supervisory Authority (European Securities and Markets Authority) (hereinafter “ESMA”) with general competence for the supervision of credit rating agencies under Regulation (EC) No 1060/2009 of the European Parliament and the Council and, as a body with highly specialised expertise, that Regulation entrusts ESMA with the development of draft regulatory technical standards.
- (2) Article 21(4)(d) of Regulation (EC) No 1060/2009 requires ESMA to submit draft regulatory technical standards by [insert date] for endorsement by the Commission on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) thereof.
- (3) Article 8(3) of Regulation (EC) No 1060/2009 requires a credit rating agency to use credit rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.
- (4) Regulation (EC) No 1060/2009, as amended by Regulation (EU) No 513/2011, in particular Article 22a thereof, requires ESMA to regularly examine compliance with Article 8(3), including verifying the execution of back-testing by credit rating agencies, analysing the results of that back-testing and verifying that the credit rating agencies have processes in place to take into account the results of that back-testing into their credit rating methodologies.
- (5) This Regulation is necessary to ensure transparency in the assessment carried out by ESMA and consistent harmonisation of the requirements set out in Article 8(3) and Article 22(a) of the Regulation
- (6) Regulation (EC) No 1060/2009, in particular Article 23 thereof, does not permit ESMA, the Commission or any public authorities of a Member State to interfere with the content of credit ratings or methodologies. Accordingly, this Regulation lays down the rules by which those method-

ologies are to be assessed but does not permit those authorities to decide on their accuracy of a credit rating produced by those methodologies.

- (7) Article 8(2) of Regulation (EC) No 1060/2009 provides that credit rating methodologies shall use all information available to a credit rating agency that is relevant to its analysis and shall include measures to ensure that information is of sufficient quality and from reliable sources.
- (8) Article 8(5) of Regulation (EC) No 1060/2009 requires a credit rating agency to monitor credit ratings and review its methodologies in particular where material changes occur that could have an impact on a credit rating.
- (9) Article 8(6) of Regulation (EC) No 1060/2009 requires a credit rating agency which changes its methodologies, models or key rating assumptions to immediately disclose the likely scope of credit ratings to be affected, review those affected credit ratings as soon as possible and, where necessary, re-rate all credit ratings that have been based on those methodologies, models or key rating assumptions.
- (10) Point 9 of Section A of Annex I of Regulation (EC) No 1060/2009 requires a credit rating agency to establish a review function responsible for periodically reviewing its methodologies, models and key rating assumptions, such as mathematical or correlation assumptions, and any significant changes or modifications thereto as well as the appropriateness of those methodologies, models and key rating assumptions where they are used or intended to be used for the assessment of new financial instruments.
- (11) This Regulation is based on the draft regulatory technical standards submitted by ESMA to the Commission for endorsement by the Commission pursuant to the procedure laid down in Regulation (EU) No 1095/2010.
- (12) ESMA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Securities and Markets Stakeholder Group established under Article 37 of Regulation (EU) No 1095/2010.

HAS ADOPTED THIS REGULATION:

Article 1

Subject matter and scope

1. This Regulation shall apply to all credit rating agencies that have been registered or certified according to Regulation (EC) No 1060/2009.
2. This Regulation lays down the rules to be used in the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009.

3. Credit rating agency shall demonstrate to ESMA its compliance with the requirements set out in Article 8(3) relating to the use of credit rating methodologies.

Article 2

Use of these rules by ESMA

1. ESMA shall assess the compliance of credit rating methodologies with Article 8(3) of Regulation (EC) No 1060/2009 in accordance with the rules laid down in this Regulation.
2. ESMA shall examine compliance by each credit rating agency with Article 8(3) of Regulation (EC) No 1060/2009 in relation to an application for registration under that Regulation and thereafter as ESMA sees fit.
3. In carrying out its obligation in Article 2(1), ESMA shall use all information relevant to the development, approval, use and review of credit rating methodologies.
4. In determining the appropriate level of assessment, ESMA shall consider whether a credit rating methodology has a demonstrable history of consistency and accuracy in predicting creditworthiness and may have regard to methods of validation such as appropriate default or transition studies designed to test that specific methodology.

Article 3

(Article 8(3) of Regulation (EC) No 1060/2009)

Assessing that a credit rating methodology is rigorous

1. A credit rating agency shall use credit rating methodologies:
 - (a) that are clear and robust controls and processes for its development and approval that allow for suitable challenge.
 - (b) that incorporate all factors relevant in determining creditworthiness of a rated entity or a financial instrument which shall be supported by statistical, historical experience or evidence.
 - (c) that take into account the modelled relationship between rated entities or financial instruments of the same risk factor and the modelled relationships between risk factors.
 - (d) and their associated analytical models, key credit rating assumptions and criteria that are reliable, relevant and of sufficient quality.
2. A credit rating agency shall list and justify for the credit methodologies used:
 - (a) each qualitative factor, including the scope of qualitative judgment for that factor; and
 - (b) each quantitative factor, including key variables, data sources, assumptions, modelling and quantitative techniques.
3. The justification in paragraph 2 shall include the following:

- (a) an explanation of the importance of each qualitative or quantitative factor used within that methodology including, where relevant, a description of and justification for related weightings assigned to those factors and their impact on credit ratings;
 - (b) the interrelationship between macroeconomic data and its impacts on the key assumptions used in that credit rating methodology; and
 - (c) an assessment of the interrelationship between the key credit rating assumptions and the volatility of credit ratings over time.
4. A credit rating agency shall use credit rating methodologies and their associated analytical models, key credit rating assumptions and criteria that promptly incorporate findings from an internal review undertaken by:
- (a) the credit rating agency's independent members of the administrative or supervisory board;
 - (b) its review function; and
 - (c) or any other relevant person or committee involved in the monitoring and reviewing of credit rating methodologies.

Article 4

(Article 8(3) of Regulation (EC) No 1060/2009)

Assessing that a credit rating methodology is systematic

1. A credit rating methodology and its associated analytical models, key credit rating assumptions and criteria shall be applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it.
2. A credit rating methodology shall be capable of promptly incorporating the findings from any review of its appropriateness.

Article 5

(Article 8(3) of Regulation (EC) No 1060/2009)

Assessing that a credit rating methodology is continuous

1. A credit rating agency shall use credit rating methodologies that:
 - (a) ensure that credit ratings are responsive to changes in market conditions over time;
 - (b) continue to be used unless there is an objective reason for it to change or be discontinued; and

- (c) are capable of promptly incorporating any finding from on-going monitoring or a review, in particular where changes in macroeconomic or financial market conditions would be capable of affecting credit ratings produced by that methodology.

Article 6

(Article 8(3) of Regulation (EC) No 1060/2009)

Assessing that a credit rating methodology is subject to validation based on historical experience including back testing

1. A credit rating agency shall use credit ratings methodologies that rely on quantitative evidence of the discriminatory power of the methodology.
2. A credit rating agency shall use credit rating methodologies based on statistical techniques that demonstrate:
 - (a) the robustness and predictive power of credit ratings over appropriate time horizons and across different asset classes; and
 - (b) the degree to which the default probabilities or expected losses predicted by the rating model match the actual default and loss rates.
3. The validation of a credit rating methodology shall be designed to:
 - (a) examine the sensitivity of a methodology to changes in any of its underlying assumptions, including qualitative or quantitative factors;
 - (b) perform an adequate and appropriate assessment of historic credit ratings produced by means of that credit rating methodology;
 - (c) use reliable inputs, including appropriate size of the data samples; and
 - (d) for each of the credit rating categories rated (such as structured finance, sovereign, corporates, financial institutions, insurances, public finance) take appropriate account of the main geographical areas of the rated entities or financial instruments.
4. A credit rating agency shall use credit rating methodologies that incorporate procedures designed to ensure that systemic credit rating anomalies highlighted by back-testing are identified and that appropriately addressed.
5. A credit rating methodology shall include:
 - (a) regular credit rating and performance reviews on rated entities and financial instruments;
 - (b) in-sample and out-of-sample testing; and
 - (c) historic information on validation or back-testing.

Article 7

Entry into force

This Regulation shall enter into force [on the 20th day] following its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

*[For the Commission
The President]*

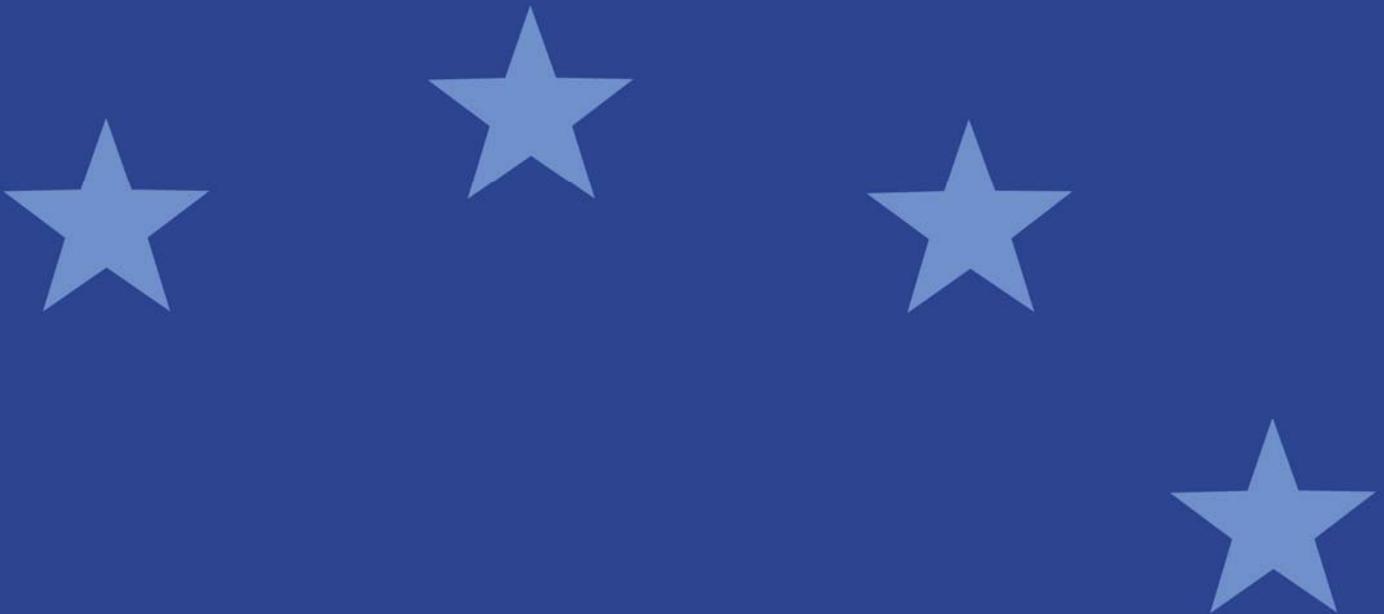
*[For the Commission
On behalf of the President]*

[Position]



European Securities and
Markets Authority

Annex II





IMPACT ASSESSMENT

Accompanying document to the consultation on:

Regulatory technical standards on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009

IMPACT ASSESSMENT

Accompanying ESMA draft Regulatory Technical Standards on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of the Regulation (EC) 1060/2009

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Executive Summary

1. This Impact Assessment provides an analysis of the draft RTS that ESMA shall submit in the area of the Regulation (EC) No 1060/2009 in accordance with Article 21 (4) (d). This draft RTS shall be submitted for endorsement by the Commission by 2 January 2012.
 2. The proposed draft RTS that is analysed in this document is designed to ensure that the implementation of the proposed draft RTS is consistent with the objectives of the Regulation.
 3. This impact assessment examines the cost and benefits that are linked to the implementation of the proposed draft RTS in respect of the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of the Regulation.
 4. It should be read in combination with ESMA's consultation document on the assessment of the compliance of credit rating methodologies with Article 8(3) of the Regulation.
-

I Introduction

7. The Regulation (EU) No 513/2011 amending Regulation (EC) No 1060/2009 (CRA I) on credit rating agencies (hereafter the EU Regulation) was published last 31 May 2011. Article 21(4) (d) requests ESMA (to submit draft Regulatory Technical Standard for endorsement by the Commission on the assessment of the compliance of credit rating methodologies with Article 8(3) of the EU Regulation. Article 8(3) of the EU Regulation provides that a credit rating agency (CRA) should use rating methodologies that are rigorous, systematic, continuous and subject to validation.
8. As required by the original of the Regulation (CRA I), CESR issued a guidance (CESR/Ref.10-945, CESR Guidance) that primarily sets out the typical information that competent authorities expect to receive from CRAs in order to assess the compliance of credit rating methodologies in accordance with their on-going supervision responsibilities under the CRA I. This guidance was made following a public consultation conducted by CESR. The amendment to the CRA I recast Article 21(3) as a new Article 21 (4) (d) that provides a mandate for ESMA to submit a draft RTS by 2 January 2012 on the same issue.
9. This impact assessment examines the cost and benefits that are linked to the implementation of the proposed draft RTS regarding the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of the Regulation.

II Procedural issues and consultation of interest parties

10. In issuing its guidelines on the regime of compliance of credit rating methodologies with the EU Regulation, ESMA shall meet the requirements set out in Article 10 (1) of its establishing Regulation (EU) No 1095/2010. Procedural requirements compel ESMA to conduct, where appropriate, a prior public consultation and cost-benefit analysis on the content of this draft RTS, and to request the opinions of the Securities and Markets Stakeholder Group established according to Article 37 of the ESMA Regulation.
11. Pursuant to the requirements explained above, ESMA has published, on 26 May 2011 a "Call for evidence on the assessment of the compliance with the Article 8(3) of the EU Regulation. (ES-

MA/2011/155) with the aim to gather information from CRAs and other interested parties in preparing the public consultation paper on the RTS and the analysis of the potential related costs and benefits, as required by Article 10 of the ESMA Regulation.

12. The Call for Evidence closed on 20 June 2011; ESMA has received 8 responses of which 5 from CRAs No.1095/2010/EU and 3 from interested parties (association of banks). These responses have as far as possible been taken into account in developing the analysis presented in this document.
13. The consultation period will close on 21 October 2011. ESMA will the review the responses from the consultation and publish its final report concerning the draft RTS on the assessment of the compliance with article 8(3) of the Regulation by the 2 January 2012.

III Economic Background

14. Transparency of the process of designing, monitoring and reviewing credit rating methodologies is an important objective of the EU Regulation. Transparency of the processes and reliability of the data used by the CRAs provides for information to the users of ratings and to investors while comparing credit rating methodologies issued by CRAs. Even though the transparency of the rating process is a key objective of the Regulation, the aim of Article 8(3) is to increase the market participants' ability to understand credit rating methodologies as well as the methodological differences across CRAs.
15. The information provided in this section is based on publicly available data as well as data provided by the respondents to the Call for Evidence, the accuracy of which ESMA has not been in the position to verify.
16. CRAs which responded to the Call for Evidence launched by ESMA have highlighted that the compliance with the requirement of Article 8(3) already resulted in organisational changes in the rating process in terms of independence of the credit policy function.
17. Some of the respondents to the Call for Evidence provided estimates of the cost and benefit of compliance with the Regulation and the expected costs of implementation of the RTS. These indications are set out below:
 - a. One CRA indicated that the compliance with the requirements of Article 8(3) has resulted in costs over the last three years that could be estimated around 6- 8 million euros.
 - b. A second CRA mentioned that the compliance with Article 8(3) have had a direct impact on the criteria used for designing credit rating methodologies.
 - c. A CRA provided an estimate of that costs of around 100 000 Euros considered significant if compared to the level of revenues of the CRAs.
18. It shall be noted that the data provided above do not represent an estimate of the impact of the compliance with the RTS related to the assessment of Article 8(3) but rather estimated costs of the compliance with different requirements of the Regulation of which some have been already borne by CRAs.
19. ESMA points out that due to the differences in the nature and scarcity of the information provided by the CRAs it is not possible to present an analysis in an aggregated format.

IV Objective

20. The objective of this impact assessment is to assess the costs (adjustment and opportunity costs) and benefits that are linked to the implementation of Article 21 (4) d of the EU Regulation. This impact assessment should be read in combination with ESMA's consultation document to which it is annexed.

V Methodology

21. In order to assess the costs and benefits linked to the assessment of the compliance with the requirements set out in Article 8(3), ESMA has identified the following costs and benefits for the following stakeholders :
- Market participants (all stakeholders: investors, issuers, etc.);
 - ESMA;
 - CRAs.
22. The analysis provides a high-level view of the potential impact of these costs and benefits on the above stakeholders in both the short and the medium/long term.
23. The analysis differentiates between the cost, which are discussed individually for ESMA and the CRAs and the benefits that are treated collectively for all market participants including issuers and any kind of investors.
24. The costs and benefits that have been considered in this analysis are set out below:

COSTS

a) For ESMA

- a. supervisory costs: assessments costs and on-going supervision costs;
- b. legal and reputational costs.

b) For CRAs

- a. compliance costs;
- b. operational costs;
- c. business opportunity costs;
- d. legal and reputational risks.

BENEFITS (for all stakeholders)

- The effectiveness of the compliance of CRAs with Article 8(3).
- The enhancement of the quality and accuracy of credit rating methodologies for all market participants.

OVERALL IMPACT

25. The overall impact of the costs and benefits are represented using the following scale system:

Key of the impact of the overall costs and benefits on stakeholders		
High	Medium	Low
√√√	√√	√

26. The final assessment of the cost-benefits analysis is done by calculating the impact of the overall costs and benefits for all stakeholders. This requires using different weights in order to calculate the overall impact and reflect the impact of the costs of each stakeholder group taking into account its specific role:

Weighting System	
Costs for ESMA	Costs for CRAs
50%	50%

VI The assessment of the compliance of CRAs with Article 8(3)

27. In August 2010, CESR issued its 'Guidance on common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3)' (CESR/Ref. 10-945), as required by Article 21(3) of the EU Regulation.
28. In December 2010, the EU Parliament and the Council adopted the amending EU Regulation, published on 11 May 2011, in order to transfer full responsibility for the supervision and enforcement of CRAs in Europe to ESMA from the second half of 2011. The EU Regulation tasked ESMA through Article 21.4 (d) with the development of draft RTS on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3).

COSTS

IMPACT ON ESMA

- Supervisory costs

29. ESMA would have to review and assess the compliance of CRAs with the requirements set out in Article 8(3) of the EU Regulation and in particular the way a CRA meets its constituents and their combination. The burden of these reviews is likely to be significant especially in the short term because of the initial learning costs.
30. However, ESMA should also monitor and assess on an on-going basis the compliance of CRAs with their initial conditions of registration and that their credit rating methodologies continue to comply with the EU Regulation and most specifically with the requirements set out in Article 8(3). ESMA

should also assess whether any material changes of the credit rating methodologies could represent a significant departure from the current approach which could lead to a material impact on the credit ratings.

31. The development of an assessment approach should be applied to any credit rating methodologies and credit rating categories using different combinations of qualitative or quantitative factors. Therefore, the requirements related to the assessment of the back-testing tests should be sufficiently general to avoid that a credit rating methodology could be rejected out of hand.

- Legal and reputational risks:

32. The legal and reputational risk for ESMA in respect of the assessment of the compliance with the requirements of Article 8(3) refer to:

- The establishment of prescriptive requirements of how CRAs should organise themselves in a coherent and effective manner the process of establishing, reviewing and updating credit rating methodologies to facilitate the assessment by ESMA of the compliance of the CRAs with the Regulation;
- The risks that some requirements could lead to the creation of interferences with the content of the credit ratings and credit rating methodologies and with the. Such interferences would impair the analytical independence and would be in conflict with Article 23 of the EU Regulation.
- The risk leading to validate credit rating methodology putting then ESMA in a conflict of interest situation.

OVERALL ASSESSMENT

33. On the basis of the above, it can be concluded that the overall impact of the assessment of the compliance by ESMA of CRAs with the requirements set out in Article 8(3) in terms of costs for ESMA is medium in the short term because of the heterogeneity of existing procedures to be supervised with all the legal consequences that follow therefrom, and medium to low in the medium to long term as the burden linked to the on-going supervision of the credit rating methodologies will be reduced through the process of learning by doing.

Costs for ESMA	
Short Term	Medium/Long Term
√√	√√

IMPACT ON CRAS

Compliance costs

34. The CRAs could have to bear significant initial costs linked to the provision of the information resulting from their compliance with the requirements of the attached draft RTS. These costs may be significant as some CRAs are using a high number of credit rating methodologies including different analytical approach and methodologies-setting process.

Operational costs

35. In the short term, some adjustments linked to the implementation of this RTS may generate significant costs (e.g. costs of preparing documentation demonstrating compliance) which could be not negligible given the broad scope of the Article 8(3) and its related draft RTS. Therefore, the implementation of this draft RTS could also lead to more granular procedures or policies that could make the credit rating methodology process more rigid.
36. The above costs are consistent with some responses received from the Call for Evidence which highlighted how CRAs would be reluctant to modify their internal procedures and to produce written policies on all the aspect of the draft RTS on the ground of substance and proportionality. Furthermore, small CRAs could face higher proportionate costs as the compliance with the proposed RTS could result in significant sunk costs.

Opportunity costs

37. The compliance and the operational costs created by the compliance with the requirements of this draft RTS may increase as the procedures for the collection, elaboration and transmission of the information underlying these draft RTS becomes more burdensome, alongside the control and monitoring mechanisms which would ensure the quality of credit rating methodologies.
38. The requirements of the proposed draft RTS may convince some CRAs to stop rating certain debt instruments. Once CRAs methodologies are based on non-public information, this in turn could require additional availability from the rated entity to the CRAs to the detriment of the new entrants.

Legal and reputational risks

39. The assessment of the compliance with the requirements of Article 8(3) would bring additional legal and reputational risk for the CRAs as a consequence of its responsibility of using credit rating methodologies which does not comply with the requirements of this draft RTS to which this document is annexed.
40. However, the extent and materiality of these risks should be mitigated as the compliance with Article 8(3) refers more generally to the rest of the Article 8 without prejudice of the compliance with the EU Regulation as a whole.

OVERALL ASSESSMENT

41. On the basis of the arguments above, it can be concluded that the impact on the costs for CRAs is high to medium in the short term, because the costs will be partly borne by issuers, and medium to low in the medium to long term, as the increase of costs levied on CRAs would be gradually reduced.

Costs for CRAs	
Short Term	Medium /Long Term
√√√	√√

BENEFITS FOR STAKEHOLDERS

42. In terms of benefits for the market, the conditions set out in this draft RTS seem to be particularly effective in order to ensure a higher level of the overall credit rating process and credit rating methodologies used by the CRAs in the EU. This potential is based on the possibility for ESMA to rely upon an additional layer of supervisory tools resulting from the assessment of CRAs with Article 8(3) of the EU Regulation.
43. All market participants should in general benefit from the implementation of the draft RTS in terms of enhancement of the transparency, credibility and validity of the credit ratings amongst investors as well as what it brings with it and through on-going supervision of CRAs activities. This draft RTS could also lead to enhance the competition among CRAs and level of protection of the issuers across the EU.
44. This applies in first place to the transparency of the credit rating methodologies and their better understanding by issuers and investors in the areas where a significant increase in the quality and transparency could be expected
45. The compliance with this draft RTS could lead to the development of credit rating methodologies that involves more transparency regarding changes in their content to make the process for all market participants more predictable and reliable. This can be optimised by setting more regular public consultation.

OVERALL ASSESSMENT

46. For the reasons above, the impact of the benefits for stakeholders can be indicated as medium in the short term, and high to long term.

Benefits for stakeholders ()	
Short Term	Medium /Long Term
√√	√ √√

VII Summary of the Impact Assessment

47. The analysis presented in section VI has addressed the impact on some stakeholders (ESMA, CRAs and market participants) from the point of view of the costs and benefits which the annexed draft RTS bring to them. Taking the aggregated results, the impact assessment of in both the short and the medium to long term is as follows:

Calculation of the overall cost impact of the regime of compliance of credit rating methodologies with the EU Regulation					
Stakeholders		ESMAs	CRAs	Aggregated costs	Overall Impact
<u>Short term</u>	cost	√√	√√√	√√/√√√	Medium to High
	weight	50%	50%		
<u>Long term</u>	cost	√√	√√	√√	Low to medium
	weight	50%	50%		

48. The overall costs impact can be then compared with the expected benefits over the short term and medium to long term:

Impact of the benefits of the regime of compliance of credit rating methodologies with the EU Regulation		
Stakeholders	Benefits	Overall Impact
Short term	√√	Medium
<u>Long term</u>	√√√	High

49. From the comparison illustrated in the table below it appears that the regime of compliance of credit rating methodologies with the EU Regulation provides significant benefits in the long term, while in the short term the benefits are reduced from adjustment costs derived from the compliance of CRAs with the requirements set out in Article 8(3) and possible reputational and legal risks for ESMA and CRAs.

SUMMARY OF THE IMPACT ASSESSMENT		
	COSTS	BENEFITS
<u>Short term</u>	Medium to High	Medium
<u>Long term</u>	Low to Medium	high

50. The costs of the implementation of the regime of compliance of credit rating methodologies with the EU Regulation can be significant in the short term, as it could increase the supervisory costs and legal risks incurred by ESMA, and the adjustment and operational costs for CRAs.

51. However, the impact on the costs side should be reduced in the medium to long term. This is because of the potential learning by doing effect and that CRAs could partly share the costs incurred by the Regulation with issuers.

52. In conclusion, the regime of compliance of credit rating methodologies set out in ESMA's draft RTS would also deliver significant benefits for the stakeholders in the short term that would gradually increase in the medium/long horizon as the expected outcomes generated by this RTS materialise.

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