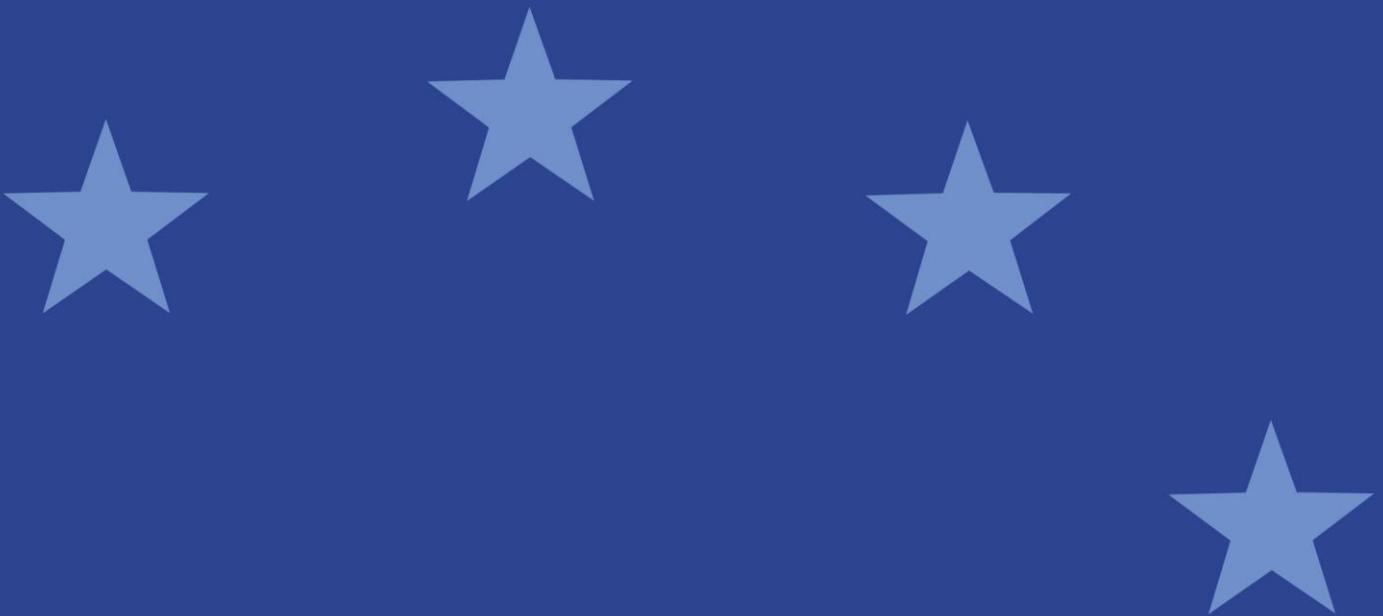




European Securities and  
Markets Authority

# Final Report

Draft RTS on the assessment of compliance of credit rating methodologies with CRA Regulation



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## **Acronyms used**

CRA	credit rating agency
RTS	Regulatory Technical Standards
ESMA	European Securities and Markets Authority
CESR	Committee of European Securities Regulators

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## I. Executive summary

### Reasons for publication

The Regulation (EU) No 1095/2010 establishing the European Securities and Markets Authority (ESMA Regulation) empowers the European Securities and Markets Authority (ESMA) to develop draft regulatory technical standards (RTS) where the European Parliament and the Council delegate power to the European Commission (Commission) to adopt regulatory standards by means of delegated acts under Article 290 TFEU.

Article 21(4) of the Regulation (EU) No 1060/2009 on credit rating agencies (CRA Regulation) as amended by Regulation (EU) No 513/2011 mandates ESMA to “submit draft regulatory technical standards for endorsement by the Commission in accordance with Article 10 of Regulation (EU) No 1095/2010 on: (d) the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3);”.

For the purpose of discharging its mandate, ESMA decided to enhance the existing Guidance on common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) (CESR/10-945). ESMA consulted market participants on the proposed draft RTS and cost-benefit analysis carried out on 19 September 2011. The Securities and Markets Stakeholder Group (SMSG) established under the ESMA Regulation, the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) have also been consulted.

### Contents

ESMA has considered the feedback it received to the consultation in drafting this RTS in accordance with Article 10 of the ESMA Regulation. This document sets out a summary of the responses received by ESMA; describes any material changes to the proposed RTS and the cost-benefit analysis on which ESMA consulted from the 19 September to the 21 October 2011; and includes the final draft RTS which will be submitted to the Commission.

### Next steps

The draft RTS will be submitted for adoption by the Commission according to Article 21(4) of the CRA Regulation.

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## **II. Background**

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. When preparing the draft RTS, ESMA considered CESR Guidance on common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) (CESR/10-945). The Guidance dealt with 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.
3. After giving due consideration to the costs and benefits (refer to Annex III of this final report), ESMA decided to use the existing Guidance as the basis for drafting the RTS, whilst enhancing their contents.
4. 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”.
5. Article 21(7) of the EU Regulation commits ESMA to cooperate with EBA and EIOPA in performing its tasks and to 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.
6. On 19 September 2011, ESMA released a Consultation Paper on ESMA’s proposed development of Article 8(3) of the EU Regulation to give market participants the opportunity to comment on the draft RTS and the cost-benefit analysis. The consultation period was closed on 21 October 2011. ESMA also consulted the MSG, EBA and EIOPA on the draft RTS.
7. The aim of the consultation was to ask stakeholders to provide comments on the draft of RTS and the impact assessment. The consultation closed on 21 October 2011 and ESMA received 9 responses from a wide range of stakeholders including 5 CRAs, one bank, one association of banks, one exchange and one individual. As stated in the ESMA Regulation, the ESAs (EIOPA and EBA) were also consulted as was ESMA’s Securities Market Stakeholder Group. All responses received, with the exception of those treated as confidential, are available on the ESMA website at <http://www.esma.europa.eu/index.php?page=consultation&mac=o&id>.
8. The final version of the draft RTS will be sent to the European Commission by 2 January 2012.

## **III. Feedback on the consultation and changes to the final draft RTS and cost-benefit analysis**

9. ESMA consulted on its draft RTS by means of a consultation paper (CP) that was published on 19 September 2011 (ESMA/2011/209). ESMA received 9 responses to the CP. Feedback was provided by Credit Rating Agencies (CRAs), one financial institution, one exchange, one association of banks and one individual. The consultation period was closed on 21 October 2011. ESMA has consulted EBA, EIOPA and the Securities and Markets Stakeholders Group (MSG) on the draft RTS.



10. The following sections describe the changes made to the final draft RTS after considering comments received from the different interest parties. The final version of the draft RTS are set out in Annex IV of this final report.

### **I. General comments**

11. Overall, respondents welcomed the consistency that had been achieved with the draft RTS which has reached to clarify the scope of the draft RTS over the CESR Guidance CESR (10-945) which was broader. A majority of respondents also welcomed that the Draft RTS would ensure that credit rating methodologies will properly reflect changing markets conditions, ensuring adequate transparency and disclosure. Hence, some respondents considered the requirements of Article 8(3) being one of the most important requirements put forward in Regulation (EC) No. 1060/2009 as the methodologies and criteria that underlie each and every credit rating are among the most essential aspects of a rating decision.
12. Respondents from the CRAs industry felt that the draft RTS should pay attention to remaining within the scope of the Regulation and not interfering with the analytical substance of the credit rating methodologies. The same respondents went further considering that some rules of the draft RTS made compliance of the credit methodologies with the back testing obligation almost exclusively on quantitative evidence. Similarly, those respondents consider that the rules proposed in the draft RTS should pay attention to the risk of confusion between credit rating methodologies, models and assumptions. Some of the aforementioned respondents requested that the RTS should not request CRAs for a prompt incorporation of findings that follow any reviews without being carefully considered.

### **II. Changes to the final draft RTS**

#### **Question 1 do you agree with the list of requirements to assess whether a credit rating methodology is rigorous?**

13. Several respondents agreed with the list of requirements proposed by ESMA that CRAs incorporate into their analysis all the factors relevant in determining creditworthiness and that the analytical models should be based on reliable assumptions. It was also suggested by one respondent limiting the discretionary use of CRAs methodologies without prejudicing the responsiveness of ratings to changes in markets conditions. One respondent also suggested that documentation of credit rating methodologies and policies must be required.
14. For one respondent, CRAs should consult market participants on changes to their methodologies and models before implementing them. Therefore, this respondent suggested that CRAs should also be required to follow a certain timeframe and to publish information at a specific time. Additionally, this respondent suggested creating an arbitration board to help solving any differences of opinion over developments in credit rating methodologies.
15. On the contrary, other contributors were of the view that the proposed draft RTS could lead to potential intrusion into analytical substance. It was also suggested not to confuse credit rating methodologies with models and assumptions. One respondent stressed that rating methodologies cannot be applied automatically and relying exclusively on quantitative criteria. Some respondents suggested that CRAs demonstrating their independence in methodology development and approval as opposed to al-

low for suitable challenge. The same respondent was of the view that the relevant factors should refer to factors deemed relevant by the CRA in determining creditworthiness.

**ESMA response:** ESMA carefully analysed the comments received during the public consultation and decided to modify the draft RTS asking CRAs to provide a detailed description of the methodologies used in order to prevent interferences with the analytical substance of the methodologies.

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

16. Most respondents did not foresee major issues with this requirement while it was indicated that further specification is needed to identify derogatory situations where an “objective reason” could lead to diverge from the requirements described in Article 5.
17. One respondent considered that the same assumptions, methodologies and conclusions should be applied consistently to comparable issuers or financial products.
18. Respondents from the CRAs industry were of the view that no additional requirements need to be added to the requirements of Article 5 of the draft RTS. It was also noted that the proposed drafting could go beyond the scope of the draft RTS which should be confined to credit methodologies.
19. While respondents welcomed the incorporation of the findings resulting from any reviews, some respondents stressed that CRAs should be required to do so after careful consideration.

**ESMA response:** the suggestion made by some respondents to the public consultation to incorporate findings only after careful consideration was not accepted by ESMA. Indeed, ESMA believes that this suggestion would lead to the delay of adjustments to be taken by the CRAs.

**Question 3: Do you agree with the list of requirements set out in Article 6 defining whether credit rating methodologies are continuous?**

20. Most respondents agreed with the proposed requirements. One respondent emphasised that the basic structure of the underlying credit methodology should remain unchanged for an extended period to ensure stability and credibility of the credit ratings. In addition, this respondent considered that the continuity requirement must also apply to credit analysts.
21. One respondent suggested that credit rating methodologies should be responsive to market changes but that the adoption of a new rating methodology should be preceded by extensive information to market participants as well as an appropriate period of consultation.

22. Respondents from the CRA industry considered that the changes incorporated in the rating methodologies should be consistent with the continuity requirement which is also covered in the draft RTS. Looking further ahead, one respondent noted that credit rating methodologies are designed to apply over a wide range of market conditions and therefore does not frequently have to be changed. Accordingly, this respondent requested the deletion of Articles 6 (1) (a) and 6 (1) (c) set out in Annex IV of this final report.

**ESMA response:** in light of the comments received, ESMA considered appropriate that “structural” changes of the market conditions shall be preferred. ESMA did not consider appropriate to delete specific provisions of Article 6 of the draft RTS set out in Annex IV on this final report.

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

23. Respondents to the consultation expressed mixed views on this issue. These mixed views reflected the heterogeneity of the respondents according to whether they are users of ratings or from the CRA industry.
24. From the users side, respondents pointed out that the credit methodologies must be subject to stress tests in order to assess their predictive power and robustness. They also stressed that rating anomalies must be identified and appropriately addressed. One respondent considered that the outcome of the back testing should be published.
25. From the CRA industry side, one respondent considered that a complete validation scheme should be accompanied by a decision plan that guides to the actions to be taken. Furthermore, the same respondent asked for more clarity about the use of out-of-sample while complying with the requirement of back-testing. One other respondent considered that the application of standardised tests can bring irrelevant results due to the scarcity of the samples or the proportionality of this requirement for small CRAs.
26. Other respondents from the CRA industry were particularly concerned about the potential for interference with the content of the methodologies created by this requirement. It was pointed out that the most effective way to demonstrate the performance of credit methodologies is transparency. Also, it was stressed that the proposed requirement would require CRAs to implement an overly quantitative focus. Finally, one respondent underlines that credit ratings provide a view of relative ranking of creditworthiness and do not predict default probabilities.

**ESMA response:** based on the feedback received from the consultation, ESMA acknowledged the concerns expressed by the CRA industry on the difficulties to apply back testing only focused on quantitative factors. However ESMA maintained its overall proposal since it considered important to reflect findings obtained from the back-testing. With regard to situations where CRAs faced lack of data, ESMA decided to address specifically that concern under a new paragraph.

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



27. The majority of the respondents agreed with the impact assessment proposed by ESMA.
28. On the CRA industry side, one respondent suggested adopting a distinction between the independent CRAs and the small CRAs that belong to the same group while some more negative points were made with respect of the lack of qualitative consideration of the changes created by the new RTS and the expected benefits to the market.

**ESMA response:** as regards the Impact Assessment set out in Annex III on this final report, ESMA decided to amend the cost sections dedicated to CRAs, reflecting the comments made by the CRAs. However, this adjustment does not substantially change the remaining part of the analysis, which remains unchanged. The final analysis is set out in Annex III of this final report.

### **III. Conclusion**

29. Having given due consideration to all the responses to the public consultation and the feedback from EBA and EIOPA<sup>1</sup>, ESMA published in Annex IV of this final report, the final draft RTS concerning the assessment of compliance of credit rating methodologies with the requirements set out in Article 8 (3) of the CRA Regulation.

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<sup>1</sup> The Securities Market Stakeholder Group decided not to provide advice on this occasion.



## **Annex I**

### **Questions to market participants**

Preliminary question: 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:

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?

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

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

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

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## **Annex II**

### **Legislative mandate to develop technical standards**

The Regulation 1095/2010/EC establishing the European Securities and Markets Authority, empowered ESMA to develop draft regulatory technical standards where the European Parliament and the Council delegate power to the Commission to adopt regulatory standards by means of delegated acts under Article 290 TFEU.

Article 21(4) of the Regulation 1060/2009/EC provided that: “ESMA shall submit draft regulatory technical standards for endorsement by the Commission in accordance with Article 10 of Regulation (EU) No 1095/2010 on:

(...)

(d) the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3);

(...)

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## **Annex III**

### **Impact Assessment**

*Pursuant to Article 10 (1) of Regulation (EU) No 1095/2010 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 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 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. The conclusions of this impact assessment assign preference to the proposal consisting in requiring CRAs to submit specific information on how they shall demonstrate their compliance with Article 8(3) of the Regulation.
5. The preferred option is expected to improve transparency and quality of the credit rating methodologies and the higher potential that the rules detailed in the draft RTS would have to support the assessment of the compliance of CRAs with Article 8(3). The benefits of this potential do not seem to be offset by higher relative cost linked to the implementation of this proposal.

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#### **II. Introduction**

7. The Regulation No 513/2011 amending Regulation 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.

### **III. Objectives, procedural issues and consultation of interest parties**

10. 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.
11. 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.
12. 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. (ESMA/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.
13. 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.
14. The consultation period closed on 21 October 2011. ESMA has received 9 responses from a wide range of stakeholders including 5 CRAs, one bank, one association of banks, one exchange and one individual.

### **IV. Economic Background**

15. 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.
16. 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.
17. 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.



18. Some of the respondents to the Call for Evidence and, to a lesser extent, to the consultation paper, 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.
19. 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.
20. However, 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.

## **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; 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:

<b>Key of the impact of the overall costs and benefits on stakeholders</b>		
<b>High</b>	<b>Medium</b>	<b>Low</b>
√√√	√√	√

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:

<b>Weighting System</b>	
<b>Costs for ESMA</b>	<b>Costs for CRAs</b>
<b>50%</b>	<b>50%</b>

**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:
- a. 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;
  - b. 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.
  - c. 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.



<b>Costs for ESMA</b>	
<b>Short Term</b>	<b>Medium/Long Term</b>
√√	√√

## 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 or from the public consultation 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 do 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 and after the public consultation has clarified the type of information that could have been requested, it can be concluded that the impact on the costs for CRAs is high 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.

<b>Costs for CRAs</b>	
<b>Short Term</b>	<b>Medium /Long Term</b>
√√√	√√

**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. The benefits of the rules proposed have been echoed in the responses provided particularly by institutional investors and the issuers representatives that have contributed to the Call for Evidence or responded to the Consultation Paper.
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.

<b>Benefits for stakeholders ()</b>	
<b>Short Term</b>	<b>Medium /Long Term</b>
√√	√√√

**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:

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

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

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

49. From the comparison illustrated in the table below it appears that the regime of compliance of credit rating methodologies with the 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.

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

50. The costs of the implementation of the regime of compliance of credit rating methodologies with the 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 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.



## Annex IV

### Draft Regulatory Technical Standards

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 2012

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<sup>2</sup>, and in particular point (d) of Article 21(4) thereof,

Whereas:

- (1) 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.
- (2) This Regulation is necessary to ensure transparency in the assessment carried out by the European Securities and Markets Authority (ESMA) and uniform rules regarding the requirements set out in Article 8 (2), Article 8(3), Article 8(5), Article 8(6), and Article 22(a) of Regulation (EC) No 1060/2009.
- (3) 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 should lay down the rules by which those methodologies are to be assessed but should not provide for those authorities to decide on the accuracy of a credit rating produced by those methodologies.
- (4) The requirements set out in this Regulation should be based on the Guidelines on common standards of compliance of credit rating methodologies with the requirements set out in Article 8(3) (CESR/10-945) issued by the Committee of European Securities Regulators (CESR). This Regulation clarifies the existing CESR Guidelines on the compliance of credit rating methodologies with Article 8(3) as well as the procedures to be followed by the CRAs in regard to their compliance with the Regulation.
- (5) Article 6(2) in connection with 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,

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<sup>2</sup> OJ L 302, 17.11.2009, p.1.



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.

- (6) 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 accordance with Article 10 of Regulation (EU) No 1095/2010.
- (7) 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. In addition, ESMA has launched a call for evidence in May 2011 in order to gather information from market participants.

HAS ADOPTED THIS REGULATION:

#### ***Article 1***

##### **Subject matter**

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.

#### ***Article 2***

##### **Demonstration of compliance**

A credit rating agency shall at all times be able to demonstrate to ESMA its compliance with the requirements set out in Article 8(3) relating to the use of credit rating methodologies.

#### ***Article 3***

##### **Responsibility of ESMA**

1. 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 considers appropriate.
2. In carrying out its obligation in Article 2(1), ESMA shall use all information relevant to assess the process of developing, approving, using and reviewing credit rating methodologies.
3. 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 credit worthiness



and may have regard to methods of validation such as appropriate default or transition studies designed to test that specific methodology.

#### ***Article 4***

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

#### **Assessing that a credit rating methodology is rigorous**

1. A credit rating agency shall use and apply credit rating methodologies which:
  - (a) contain clear and robust controls and processes for their developments and related approvals that allow suitable challenge;
  - (b) incorporate all driving factors deemed relevant in determining creditworthiness of a rated entity or a financial instrument which shall be supported by statistical, historical experience or evidence;
  - (c) consider the modelled relationship between rated entities or financial instruments of the same risk factor and risk factors to which the credit methodologies are sensitive; and
  - (d) incorporate reliable, relevant and quality related analytical models, key credit rating assumptions and criteria where these are in place.
2. A credit rating agency shall list and provide a detailed explanation of the credit methodologies used regarding:
  - (a) each qualitative factor, including the scope of qualitative judgment for that factor;
  - (b) each quantitative factor, including key variables, data sources, key assumptions, modelling and quantitative techniques.
3. The detailed explanation referred to in paragraph 2 shall include the following:
  - (a) a statement of the importance of each qualitative or quantitative factor used within that credit methodology including, where relevant, a description of and justification for related weightings assigned to those factors and their impact on credit ratings;
  - (b) the relationship between the key assumptions used in that credit rating methodology and the critical risk factors derived from macroeconomic or financial data; and
  - (c) an assessment of the relationship between the key assumptions used in credit rating methodology and the volatility of credit ratings produced by that methodology 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 or outcomes from an internal review or a monitoring review undertaken by one or more of the following :
  - (a) the credit rating agency's independent members of the administrative or supervisory board;

- (b) the credit rating agency's review function; and
- (c) any other relevant person or committee involved in the monitoring and reviewing of credit rating methodologies.

#### ***Article 5***

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

Assessing that a credit rating methodology is systematic

1. A credit rating agency shall use a credit rating methodology and its associated analytical models, key credit rating assumptions and criteria that are 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 agency shall use a credit rating methodology which is capable of promptly incorporating the findings from any review of its appropriateness.

#### ***Article 6***

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

Assessing that a credit rating methodology is continuous

1. Without prejudice to Article 4 (4), a credit rating agency's credit rating methodologies shall be designed and implemented in a way that enables them to:
  - (a) continue to be used unless there is an objective reason for the credit rating methodology to change or be discontinued;
  - (b) be capable of promptly incorporating any finding from on-going monitoring or a review, in particular where changes in structural macroeconomic or financial market conditions would be capable of affecting credit ratings produced by that methodology; and
  - (c) to compare credit ratings across different asset classes.

#### ***Article 7***

##### **(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 are supported by quantitative evidence of the discriminatory power of the credit rating methodology.

2. A credit rating agency shall use credit rating methodologies that describe:
  - (a) the historical robustness and predictive power of credit ratings issued using the relevant methodology over appropriate time horizons and across different asset classes; and
  - (b) the degree to which the assumptions used in the rating model deviate from the actual default and loss rates.
3. The validation of a credit rating methodology shall be designed to:
  - (a) examine the sensitivity of a credit rating 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 have processes in place to ensure that systemic credit rating anomalies highlighted by back-testing are identified and are appropriately addressed.
5. In the process of reviewing credit rating methodologies, a credit rating agency 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.
6. In cases where there is limited quantitative evidence to support the predictive power of a credit rating methodology, a credit rating agency shall be considered to comply with this Article if it:
  - (a) ensures that credit rating methodologies are sensible predictors of credit worthiness;
  - (b) applies internal procedures in a consistent way and over time and across different market segments; and
  - (c) complies with para (4) of this Article.

## ***Article 8***

### **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]

DRAFT