



European Securities and
Markets Authority

Credit Rating Agencies Annual Report 2012

Application of the Regulation (EC) No 1060/2009 as amended according to Article 21(5)

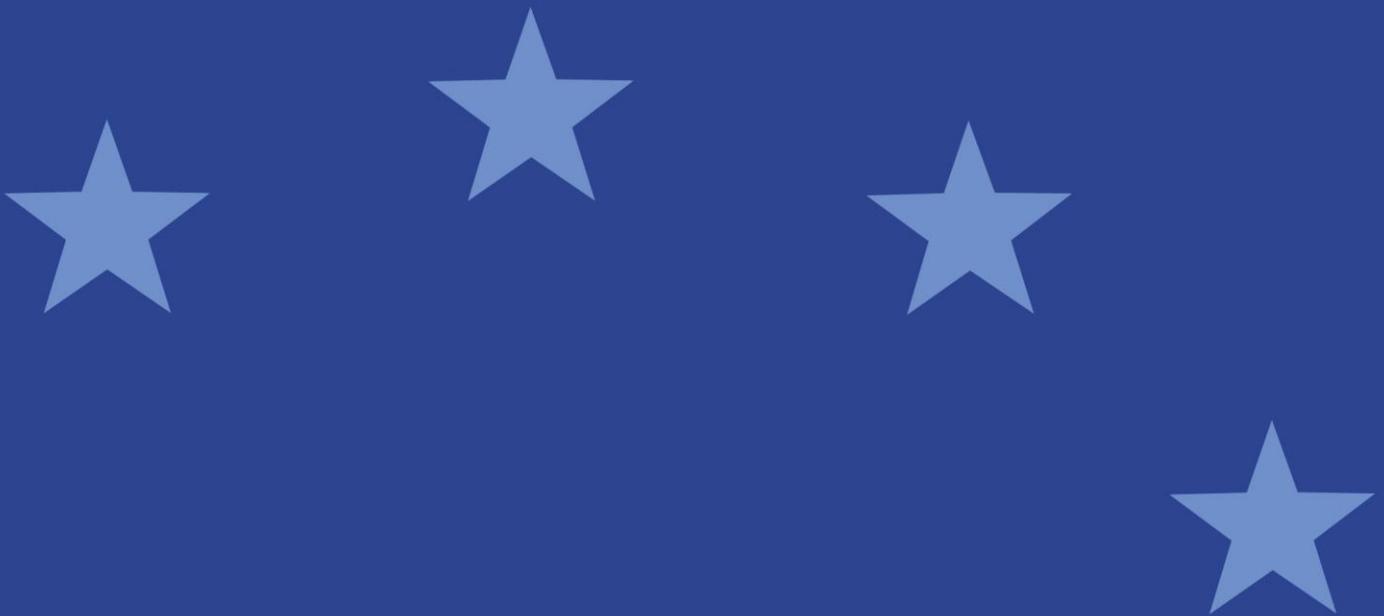


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Acronyms used

CEREP	Central Repository
CRA	Credit Rating Agency
Regulation	Regulation (EC) No 1060/2009 as amended
EC	European Commission
ESMA	European Securities and Markets Authority
EU	European Union
IOSCO	International Organization of Securities Commissions
NCA	National Competent Authority
RTS	Regulatory Technical Standards
SOCRAT	Supervision Of CRAs Tool

Executive Summary

The European Securities and Markets Authority (ESMA) has compiled its second annual report on the application of the CRA Regulation (Regulation) which provides an overview of ESMA's registration, supervision and policy activities in relation to credit rating agencies (CRAs) in the European Union (EU).

ESMA is now responsible for the supervision of 19 registered and one certified CRA. In terms of its registration function, ESMA is currently assessing several applications for registration and expects additional applications in the course of 2013.

Since the beginning of ESMA's supervision in 2011, CRAs have increased their investments in human and capital resources to address regulatory requirements. ESMA has identified some progress in CRAs' activities, in particular as regards the public disclosure of methodologies and ratings, the increase of internal control resources, the closer involvement of senior management in the governance of CRAs and improved record-keeping practices.

At the same time, ESMA believes that CRAs have not yet sufficiently embedded all the main requirements of the Regulation into their organisations. Given the continued importance of credit ratings in the financial markets and the inherent conflicts of interest associated with commercial drivers and the business models applied in this industry, ESMA believes that further improvements in the following areas are necessary:

- i) the consistent application and comprehensive presentation of rating methodologies;
- ii) the empowerment and resourcing of analytical and control functions;
- iii) the monitoring and surveillance of ratings; and
- iv) the reliability of IT infrastructures.

ESMA will also focus on these matters as part of its supervisory work plan for 2013.

Supervision, Policy and Cooperation

During 2012 ESMA identified a number of deficiencies as a result of its on-going supervision. The investigations carried out in 2012 revealed shortcomings with respect to CRAs' rating processes, governance and internal control mechanisms. Following ESMA's remedial action plans, the CRAs put in place significant measures to establish appropriate record-keeping and documentation procedures, improve data quality and confidentiality, strengthen resources dedicated to internal control functions, increase transparency in the disclosure and presentation of ratings and enhance the involvement of senior management in their activities.

ESMA also conducted a thematic investigation into bank rating methodologies. The investigation revealed shortcomings regarding the processes of disclosure and implementation of changes in bank rating methodologies, the rigorous and systematic application of methodologies and the

methodological review process. Subsequently, the remedial action plans ESMA has set in place require the CRAs, as appropriate, to incorporate all factors, models, assumptions and criteria in their methodologies, enhance transparency in methodological disclosures and changes, maintain adequate records with reference to analytical specifications of rating instruments and improve the internal review with reference to performance of the methodologies.

As part of its on-going supervision during 2012, ESMA received and analysed both quantitative and qualitative periodic information from CRAs, which has been used to define its supervisory priorities using a risk-based approach. Other on-going supervisory activities included following up on changes to CRA's organizational structure and rating statuses and addressing complaints from stakeholders as regards CRAs' alleged non-compliance with the Regulation.

The annual report also describes ESMA's risk function with a focus on the implementation of the risk analysis work and the latest developments in ESMA's central repository for ratings statistics (CEREP). The repository went live in February 2012 and disseminates consistent information on ratings data to the public, in order to improve transparency and contribute to investor protection.

Furthermore, ESMA reports on the work on policy and cooperation, including the adoption of the draft Regulatory Technical Standards (RTS), guidelines and recommendations on the scope of the Regulation, cooperation with third countries and ESMA's supervisory competences in view of the new CRA3 Regulation.

Finally, this report provides ESMA's views on trends in the industry, along with a synopsis of EU rating activity and provides information on ESMA's forthcoming investigations on sovereign and structured finance ratings which will be conducted in 2013. Through these investigations and other supervisory activities, ESMA plans to fulfil its main objective of achieving high-impact and preventative supervision in the coming period.

I. Introduction

1. ESMA is the single authority with exclusive supervisory responsibility for CRAs in the EU. The Regulation introduces a regulatory framework in order to ensure that credit rating activities are conducted in accordance with the principles of integrity, transparency, responsibility and good governance and that the resulting credit ratings are independent, objective and of adequate quality. The Regulation requires CRAs to comply with a set of requirements which include the following subjects:
 - i) use of methodologies, that should be rigorous, systematic, continuous and subject to validation;
 - ii) appropriate disclosure to the public, with particular reference to the disclosure of methodologies that are used by CRAs and the presentation of ratings;
 - iii) sound internal policies and procedures to prevent, identify, eliminate or manage and disclose any conflicts of interest; and
 - iv) arrangements for sound corporate governance.
2. Article 21(5) of the Regulation requires ESMA to publish annually a report on the application of the Regulation. This report summarises the supervisory actions and work undertaken by ESMA in the course of 2012, in order to ensure that registered CRAs comply with the requirements in the Regulation. In particular, the report describes ESMA's activities with regard to its registration and perimeter function, its on-going supervisory work and the supervisory findings following the investigations in 2012. This report also addresses other regulatory activities carried out by ESMA during the same period in the field of credit rating agencies, like the work on the risk analysis function, the IT infrastructure, the policy development work and the international cooperation in light of equivalence and endorsement.

II. Registration and perimeter

II.1 Registration

3. At the time of the publication of this report, there are 19 registered CRAs and one certified CRA in the EU.¹ Amongst these registered CRAs, Fitch Ratings (Fitch), Moody's Investors Service (Moody's) and Standard & Poor's Credit Market Services (S&P) operate under a group structure, totalling 16 legal entities. Therefore, the total number of entities registered or certified with ESMA in the EU is 33.
4. In the course of 2012, Capital Intelligence Ltd. (Cyprus), European Rating Agency a.s. (Slovakia), Axesor SA (Spain) and CERVED Group S.p.A (Italy) have been registered as CRAs in the EU. Capital Intelligence, European Rating Agency and CERVED applied for registration before the entry into force of the current Regulation, so the national competent authorities (NCAs) were responsible for the registration of these three CRAs. ESMA provided advice to the NCAs on the compliance of these applications for registration. Axesor applied under the new regime to ESMA and was registered on 1 October 2012.
5. In addition to the finalised registration applications, various other companies applied for registration or certification to ESMA during the second half of 2012. ESMA expects additional applications in the course of 2013.

II.2 Perimeter activities

6. As part of its supervision and cooperation with national competent authorities, ESMA identified, in 2012, a number of entities which appeared to be operating as a CRA in the EU without being registered with ESMA. This exercise has been part of a broader programme of activity designed to improve guidance on the scope of the Regulation and to give clarity on ESMA's approach to perimeter activities.²
7. Following its clarification on the scope of the Regulation, there will be no tolerance for credit rating agencies conducting rating activities without a registration. *Free riding* credit rating agencies will face enforcement measures by ESMA, including the suspension of such activities until the rating agency is registered. ESMA has contacted more than 25 entities, in order to identify whether their activities required registration under the Regulation. Where ESMA concluded that the activities were covered by the Regulation, such entities have been requested to apply for registration.

¹ Euler Hermes Rating GmbH, Feri EuroRating Services AG, Bulgarian Credit Rating Agency AD, Creditreform Rating AG, Scope Credit Rating GmbH (formerly PSR Rating GmbH), ICAP Group SA, GBB-Rating Gesellschaft für Bonitätsbeurteilung mbH, ASSEKURATA Assekuranz Rating - Agentur GmbH, Companhia Portuguesa de Rating S.A. (CPR), AM Best Europe - Rating Services Ltd. (AMBERS), DBRS Ratings Limited, Fitch Ratings, Moody's Investors Service, Standard & Poor's Credit Market Services, CRIF S.p.A., Capital Intelligence (Cyprus) Ltd., European Rating Agency a.s., Axesor SA, CERVED Group S.p.A and Japan Credit Rating Agency Ltd (certified).

² Consultation Paper on Guidelines and Recommendations on the scope of the Regulation (ESMA 2012/841).

III. Supervision

8. The Regulation introduced a common regulatory and unique supervisory approach to credit rating agencies in the EU in order to ensure that credit rating activities are conducted in accordance with the principles of integrity, transparency, responsibility and good governance. This section provides a summary of essential findings and remedial actions of ESMA's investigations and an outline of other supervisory activities carried out by ESMA.
9. In the following section, ESMA summarises its most relevant observations and concerns arising from its investigations in 2012. As of the date of this report, ESMA has not determined whether any observation highlighted below constitutes a breach of the provisions of the Regulation. As ESMA is still progressing in its assessment of the areas discussed in this section, these observations are published without prejudice to the possibility of further investigations which could lead to enforcement or supervisory actions.

III.1 Rating processes, governance and internal controls

10. Following its first investigations of Fitch, Moody's and S&P, ESMA published, in March 2012, a report on its supervisory findings related to:
 - i) the transparency of rating methodologies;
 - ii) the disclosure and presentation of ratings;
 - iii) the adequacy of controls over IT systems;
 - iv) the recording of core internal processes and decisions; and
 - v) the adequacy of resources devoted to internal control functions and analytical business lines.
11. In particular, ESMA observed that:
 - i) CRAs should enhance the recording of core internal processes and ensure that the documentation is distributed in a timely manner³;
 - ii) CRAs should improve processes relevant to data quality and confidentiality of information⁴;
 - iii) CRAs should ensure that their internal control functions fulfil the duties conferred to them by the Regulation⁵;

³ Article 6(2) and point 7 of Section B of Annex I of the Regulation describes how CRAs shall keep adequate records of their credit rating activities.

⁴ Reference to Article 8(2) and point 4 of Section D of the Regulation, as regards quality of the data and information used to prepare the credit ratings and their disclosure thereof.

- iv) when disclosing methodologies and presenting ratings, CRAs should aim at maximum level of transparency and ensure adherence to rigorous procedures for the disclosure of rating actions⁶;
 - v) independent directors should be actively involved in CRAs' activities⁷; and
 - vi) CRAs should put in place adequate measures to ensure that the IT environment is properly managed and controlled.⁸
12. In response to requests by ESMA to implement remedial action plans for each CRA involved, the CRAs have undertaken the following actions:

- Recording of internal processes

In relation to the recording and documentation of processes and decisions, one or more CRAs have amended their policies and procedures, accommodated IT systems and automatized certain processes. In particular, such measures included:

- i) enhancement of recording of rating activities;
- ii) minuting of internal relevant meetings where methodologies are discussed and approved; and
- iii) recording of the reasons why a rating committee decision may differ from the analysts' recommendation.

- Data quality and confidentiality

One or more CRAs have:

- i) automatized the process of manual feed of data for a specific type of credit rating;
- ii) imposed tests on the review and approval of manual data feed;
- iii) introduced ad-hoc audit on outsourcing agreements with data providers;

⁵ Reference to Article 6(2) and points 5 and 9 of Section A of Annex I of the Regulation, as regards compliance and review functions.

⁶ Section D of Annex I of the Regulation includes the rules on the presentation of credit ratings. In particular, Article 10(2) and point 2(b) of Section D of Annex I of the Regulation mandate that CRAs, shall disclose the methodology used to determine the rating, with a reference to its comprehensive description.

⁷ Reference to Article 6(2) and point 2 of Section A of Annex I of the Regulation, as regards the independent members of the administrative or supervisory board of CRAs.

⁸ Article 6(2) and point 4 of Section A of Annex I of the Regulation mandate that CRAs should have effective control and safeguards arrangements for information processing systems.

iv) incorporated research for certain elements of ratings; and

v) included controls so as to ensure that rating committee packages are only submitted to non-conflicted members.

- Internal control functions

One or more CRAs have:

i) increased the seniority and the number of resources dedicated to control functions;

ii) reinforced the resources dedicated to the internal review function;

iii) restructured the compliance function globally and in the EU (increasing senior resources);

iv) established processes for the annual review of the compliance function; and

v) reorganised reporting processes concerning internal review and compliance.

- Disclosure of methodologies and presentation of ratings

On occasions when CRAs maintained rating methodologies in multiple documents, they have combined them into a single document to improve transparency. Moreover, one CRA has further developed its methodologies to ensure their full disclosure, while one CRA has amended its policies which regard to updates and definition of peer groups, as well as the review of performance of models used in the rating process. Finally, one CRA has enhanced the controls to be performed prior to public announcements on the content, form and timing of the disclosure of credit ratings.

- Independent directors

One CRA has enhanced the independent directors' involvement in its activities and their interactions with internal control functions.

- IT audit

One CRA has strengthened the IT internal audit function in the EU offices and has established regular reporting to senior management on the activities of the quality assurance function. Moreover, one CRA enhanced its internal audit resources and professional services in the EU.

13. ESMA also conducted an investigation for a specific CRA with a focus on governance and control functions. This resulted in concerns regarding:

- i) the involvement of board members and, in particular, independent directors, in the assessment of the internal controls mechanisms⁹;
 - ii) the appropriate management of potential conflicts of interest as regards independent members of the board¹⁰;
 - iii) the resources dedicated to the internal control functions compared to the size of the CRA's activity¹¹;
 - iv) the compliance function's involvement in assessing and monitoring the credit rating process¹²;
 - v) the empowerment and role of the internal review function¹³; and
 - vi) the adequacy of resources and processes dedicated to the rating surveillance activity.¹⁴
14. In response to ESMA's requests included in its remedial action plan, the CRA under investigation undertook the following actions:
- Establishment of policies and procedures to document board discussions on internal controls and implementation of periodic reporting from the control functions to independent directors;
 - As regards independent directors, redefinition of their roles and implementation of additional measures to identify and manage potential conflicts of interests;
 - Increase of resources dedicated to control functions and amendment of policies and procedures to identify roles, responsibilities and reporting lines of internal control functions;
 - Establishment of an appropriate compliance work plan for 2013, including the introduction of concrete measures to enhance the scope of the compliance function activity;

⁹ Points 1 and 2 of Section A of Annex I of the Regulation refers to organisational requirements as regards senior management and independent members of the board. Further, point 4 of Section A of Annex I of the Regulation includes provisions concerning internal control mechanisms.

¹⁰ Point 1 of Section B of Annex I of the Regulation requires CRAs to identify, eliminate or manage and disclose any actual or potential conflicts of interest.

¹¹ Point 10 of Section A of Annex I of the Regulation requires CRAs to carry out on-going monitoring of the adequacy of its internal control mechanisms and to take appropriate measures to address any deficiencies.

¹² Reference to point 5 of Section A of Annex I of the Regulation, as regards the tasks of the compliance function.

¹³ Point 9 of Section A of Annex I of the Regulation requests CRAs to establish a review function in charge of periodically reviewing methodologies, models and key rating assumptions.

¹⁴ Reference to point 10 of Section A of Annex I of the Regulation which requires CRAs to carry out on-going monitoring of the adequacy of its internal control mechanisms and to take appropriate measures to address any deficiencies.

- Revision of the methodology review, so as to ensure an effective assessment of the qualitative and quantitative criteria used for the ratings and introduction or amendments of policies and procedures to clarify the internal review function's tasks and to empower the function in the approval process of methodologies; and
- Increase of staff dedicated to the surveillance activity and implementation of more automated systems, so as to mitigate the operational risk currently entailed in the manual feed of data.

III.2 Bank ratings methodologies

15. During 2012, ESMA conducted an investigation into the bank rating methodologies of Fitch, Moody's and S&P in respect of the following processes:
- i) set up, monitoring and review of rating methodologies;
 - ii) implementation of methodologies through the rating process;
 - iii) internal mechanisms to ensure consistent application of rating methodologies; and
 - iv) disclosure of methodologies.

The work also included on-site inspections which took place in July 2012.

16. The focus on bank ratings was based on their linkage with sovereign ratings, the number of methodological changes implemented over the period under investigation (September 2010 to August 2012) and the significant rating activity in financials in the second half of 2011 and first half of 2012.
17. ESMA reviewed a number of policies, procedures and rating committee documentation, which concerned bank rating actions in a sample of EU issuers. This information was provided to ESMA following several requests for information during the investigation period. ESMA conducted an on-site inspection at the premises of the CRAs concerned, including interviews with representatives of the CRAs, such as senior management and staff of the internal review function, the compliance and other internal control functions, as well as analytical staff from the financial institution's group.
18. ESMA identified areas of concern with respect to the process of disclosures and implementation of the methodological changes into bank ratings, the rigorous and systematic application of the methodologies and the review process of methodologies. ESMA's main findings are described below, followed by the related remedial actions required from the CRAs under investigation.

- Elements that should be incorporated in the methodology¹⁵

ESMA observed that one or more of the CRAs used various publications and / or internal guidance in its bank rating process. While these documents were not considered by CRAs as being part of their methodology, they modified the analysts' analytical framework by, for example, amending the rating factors and their relative contribution as regards bank ratings.

In ESMA's view, a methodology should incorporate all driving factors deemed relevant in determining creditworthiness as well as analytical models, key credit rating assumptions and criteria when these are in place. It should encompass:

- i) all existing methodological elements embedded in research publications or internal guidance;
- ii) outstanding practices and analytical tools used to determine bank ratings (including stress scenarios, parameters, ranges, limits and caps); and
- iii) any other systematic process used to identify the factors used in the rating assessment or to determine their relative importance.

ESMA requested CRAs to adequately codify in their methodologies all the aforementioned elements which are used in their analytical framework.

- Disclosure of methodologies¹⁶

The aforementioned observation also relates to the requirement for transparent disclosure to the public of all methodological elements. ESMA noted that one or more CRAs used innovative tools and criteria which were not publicly disclosed as amendments of the methodologies. This resulted in a discrepancy between the analytical framework effectively used by these CRAs and the methodologies officially in use and disclosed to the public at that time. ESMA also identified that for one or more CRAs, methodologies not currently in use are not published on their websites. Consequently, past rating action publications may include reference to methodologies that are no longer available.

ESMA considers that there should be a sufficient degree of transparency and detail with regard to the methodology disclosed to the public, so as to give adequate information to

¹⁵ Article 4(1) of the Delegated Regulation (EU) No 447/2012 describes what should be incorporated in a methodology, such as driving factors deemed relevant in determining the rating and reliable and relevant analytical models, key credit rating assumptions and criteria.

¹⁶ Article 10(2) and point 2(b) of Section D of Annex I of the Regulation mandate the provisions for the disclosure of the methodology used in determining the rating, with reference to its comprehensive description.

the users of credit ratings. In that respect, ESMA required CRAs to ensure that all methodological elements are properly and clearly codified, disclosed and referred to in their rating methodologies. ESMA has also asked CRAs to ensure that users of ratings can access the methodologies indicated in all rating action commentaries displayed on their website.¹⁷

- Description of importance of factors used in the rating assessment¹⁸

One or more of the CRAs were unable to provide ESMA with the following elements with regard to the relative importance of the factors used in their methodologies:

- i) the statements of the relative importance of the factors (and sub-factors);
- ii) all the technical details and specifications of the models and instruments; and
- iii) the historical evidence underlying the choice of those models and instruments.

ESMA requested the CRAs to indicate clearly each qualitative and quantitative factor used and the respective statements of their relative importance within the methodology, which should be determined on an ex-ante basis and be sufficiently detailed, documented, recorded and disclosed. ESMA also requested the CRAs to provide evidence on specification, calibration or estimation of those models or other analytical tools used (including technical details) in order to justify the relative importance of the factors used. Furthermore, ESMA asked CRAs to adapt their policies and procedures in order to maintain adequate records of all the procedures and methodologies used to determine credit ratings.

¹⁷ This should apply in respect of all rating publications displayed on the CRAs' website that relate to actions taken after the 7th September 2010 (according to Article 40 of the Regulation on transitional provisions).

¹⁸ Article 8(3) of the Regulation states that a CRA shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing. Further, Article 4 of the Delegated Regulation (EU) No 447/2012 mandates that CRAs shall list and provide detailed explanations as regards qualitative and quantitative factors used and their relative importance. In addition, Article 6(2) and point 7 of Section B of Annex I of the Regulation requires CRAs to maintain adequate records of the procedures and methodologies used to determine credit ratings.

- Review of methodologies¹⁹

The documentation regarding the annual review of one or more of the CRAs did not include any clear link between the review conducted and the re-assessment of the models, analytical components or instruments used to determine bank ratings.

Subsequently, ESMA has required CRAs to make improvements in their practices so as to be able to demonstrate that the reviews of bank rating methodologies include an analysis of the link between the performance of the methodologies and the performance of their main analytical components (such as bank stand-alone profile and external support). Reviews should also include the assessment of the list of factors and their relative importance, and, where appropriate, of the technical specifications of models and instruments used.

- Procedures relating to the implementation of a change in methodologies²⁰

ESMA observed that one or more of the CRAs, following changes in methodologies or key rating assumptions, did not place the individual affected credit ratings *under observation*.

The Regulation distinguishes the different steps a CRA must follow, after changes in methodology, criteria or key rating assumptions. CRAs should:

- i) immediately, disclose the likely scope of credit ratings to be affected;
- ii) at the time of the disclosure of the scope, place the individual affected credit ratings *under observation*;
- iii) as soon as possible and no later than six months after the change, internally review the individual ratings affected by the change; and
- iv) re-rate the affected credit ratings if following the review, the overall combined effect of the changes in methodology, models or key rating assumption affects those credit ratings.

Moreover, ESMA believes that such changes are to be understood in a broad sense, covering, for example, changes in the rating scale and/or in the rating categories,

¹⁹ Article 8(5) of the Regulation provides that a CRA shall monitor credit ratings and review its credit ratings and methodologies on an on-going basis and at least annually, in particular, where material changes occur that could have an impact on a credit rating. Further, Article 4 of the Delegated Regulation (EU) No 447/2012 mandates that CRAs shall list and provide detailed explanations as regards qualitative and quantitative factors used and their relative importance.

²⁰ Article 8(6) specifically refers to occasions when methodologies, models or key rating assumptions used in credit rating activities are changed and the relevant actions which CRAs need to undertake.

amendments or withdrawals of underlying factors used in credit rating assessment or changes in the parameters or specifications used to determine the contribution of rating factors. In this respect, ESMA requested CRAs to adapt their relevant policies and procedures accordingly and to ensure that the above steps are followed.

- Minimum information quality and timeliness standards²¹

For one or more of the CRAs, the information used for certain rating actions referred to significantly outdated data. At the same time, these CRAs have not established formal guidance on the type, quality and frequency of data and information updates to be obtained by analysts in the monitoring of banks.

ESMA requested that the CRAs establish and maintain detailed guidance defining minimum standards as regards:

- i) the type of information and data that is deemed generally sufficient to determine and monitor the ratings of banks;
- ii) the timeframe expected for the receipt of such information; and
- iii) the indicative maximum period during which the information can be considered updated and meaningful enough to support a rating action.

When deviating from that guidance, the analysts should document and report the circumstances in order to facilitate the discussion by the rating committee.

19. In February 2013, the CRAs under investigation received ESMA's remedial action plans, including the areas of concern to be addressed and the deadlines to be met by the CRAs. ESMA will monitor the implementation of these actions in the course of 2013.

III.3 On-going supervision

20. CRAs, as required by the Regulation, provided ESMA with periodic quantitative (credit ratings data, credit ratings transitions, financial information) and qualitative (internal reviews on methodologies, updates to compliance work plans, identified conflicts of interest, board minutes, other relevant reports) information. This periodic information and other supervisory information received, feeds into ESMA's risk analysis function and defines ESMA's supervisory priorities in addressing the most important risks in the CRA industry. When appropriate, an investigation has been conducted.

21. In February 2012, ESMA informed all registered CRAs about:

²¹ Reference to Article 8(2), 8(5) and point 4 of Section D of Annex I of the Regulation, as regards quality, reliability and verification or ratings information and their disclosure thereof.

- i) the draft Regulatory Technical Standards (RTS) published by ESMA on 22 December 2011;
- ii) the implementation of the endorsement mechanism;
- iii) the notification to ESMA of material changes; and
- iv) CEREP reporting and the types of periodic information ESMA expects to receive.

In its letter, ESMA collectively responded to issues that had been raised by registered CRAs such as, the means of submission of periodic information in the interim period until the entry into force of the RTS on periodic information, or the communication of notifications of changes to initial conditions for registration.

- 22. In May 2012, ESMA informed registered CRAs about the implementation of the Commission's Delegated Regulation (EU) No 272/2012 on supervisory fees. On the basis of this Regulation, the supervisory fees for 2011 and 2012 have been collected.
- 23. Furthermore, ESMA organised a half-day round table for registered CRAs in June 2012 to provide:
 - i) an overview of ESMA's supervisory approach;
 - ii) an update on the implementation of the Regulation; and
 - iii) a presentation of the upcoming CRA3 Regulation.
- 24. Throughout 2012, ESMA followed up on changes in the initial conditions of the registration within certain CRAs. Such changes regarded, but were not limited to, takeovers, changes in shareholding structures, establishment of new branches, new types of ratings issued, changes in board compositions, restructuring of control functions and business lines and modifications in analysts' rotation policies.
- 25. ESMA improved through its on-going supervision the CRAs' processes for identification and use of endorsed and unsolicited credit ratings. Moreover, ESMA stressed in a *Dear CEO* letter to various CRAs that each individual rating action, as part of a collective rating action, requires an assessment of all the available information per rated issuer or instrument.
- 26. Finally, ESMA also received complaints from stakeholders as regards CRAs' alleged non-compliance with the Regulation. For example, complaints addressed the proper disclosure of ratings and implementation of methodologies. ESMA follows up on all the supervisory issues that such complaints have raised and, when appropriate, an investigation has been conducted.

III.4 Enforcement

27. The European Commission (EC) published further rules of procedure in October 2012 for the exercise of ESMA's power to impose fines or periodic penalty payments. Such rules were adopted and clarified by means of a Delegated Regulation.²² This Delegated Regulation includes provisions on rights of defence, temporal provisions, provisions on the collection of fines or periodic penalty payments, as well as detailed provisions on the limitation periods for the imposition and enforcement of fines and periodic penalty payments.
28. As part of its duties under this Regulation, ESMA is carrying out some investigations in which it may consider whether there are serious indications of possible existence of facts liable to constitute one or more of the infringements set out in the CRA Regulation. If ESMA considers that there are such indications then it has to appoint an independent investigating officer within ESMA to investigate the matter. It has made such an appointment in one instance.

²² Commission Delegated Regulation (EU) No 946/2012, OJ L 282, 16 October 2012, p. 23.

IV. ESMA's risk function and IT infrastructures

IV.1 Risk function

29. ESMA has established a risk analysis function within the CRA Unit. The risk function has been developed to be a flexible and responsive combination of judgement-based intelligence drawn from the supervisory process, together with quantitative and qualitative information gathered through market intelligence activities. These activities are intended to form a solid framework for the strategic planning and prioritisation of ESMA's supervision.
30. The implementation of the risk analysis work within ESMA has the following objectives:
- i) capture market trends and condense, store and distribute information;
 - ii) make efficient use of existing information, infrastructure and skills;
 - iii) capture and quantify all major risks by synthesizing collected information; and
 - iv) lay the ground for risk based supervisory activities.
31. The risk analysis activities are based on two pillars:
- i) CRA impact and potential degree of damage caused by regulatory breaches; and
 - ii) event probability, in the sense of likelihood of regulatory failures and infringements.
32. The impact for each CRA is calculated on the basis of a pre-defined set of factors and weightings. Event probability is determined through individual supervisory judgement based on a pre-defined set of guidelines to ensure consistency and comparability. Judging event probability requires the supervisor to assess different risk categories for a CRA and make qualitative judgements.
33. The risk analysis framework developed in the course of 2012 has been used in the preparation of the 2013 work programme, which defines the basis for ESMA's engagement in dedicated investigations of individual CRAs and thematic issues across different CRAs.

IV.2 SOCRAT

34. In the course of 2012, ESMA worked on the development of the Supervision of CRAs Tool (SOCRAT), an internal IT tool designed to support ESMA in its regular monitoring of CRAs' activity. SOCRAT works on data that CRAs have to report to ESMA on a periodic basis.²³

²³ In accordance to the Commission Delegated Regulation (EU) No 446/2012.

This data is not be available to the public and will be only used by ESMA staff for on-going supervisory purposes.

35. CRAs are required to report, to SOCRAT, standardised information on the periodic rating actions data and related supervisory information, starting from November 2012. The information received via SOCRAT reporting will allow ESMA to supervise the conduct and activities of credit rating agencies, in order to react promptly in case of actual or potential breaches of the requirements of the Regulation.
36. The system incorporates a number of pre-defined reports that will assist supervisors in the on-going monitoring of the CRAs and will create an important database for ad-hoc queries on thematic areas of supervision. A comprehensive testing exercise was completed with the CRAs, which allows them to correctly report to the system according to the established deadlines. SOCRAT will be a valuable risk identification tool and reporting tool for ESMA.

IV.3 CEREP

37. ESMA has successfully established a Central Repository (CEREP) where registered and certified CRAs make available to the public information on the historical performance of their ratings. The purpose of CEREP is to improve transparency and to contribute to the protection of investors by providing consistent information on the performance of CRAs' ratings. The public can review data on the transition frequency of ratings, occurred defaults and overall information on the credit ratings issued.
38. CEREP was made publicly available in February 2012 and updated statistics have been released in June 2012 and in October 2012. It has been welcomed by market participants and is perceived as a useful mechanism for retrieving information on CRAs' activity and rating performance.
39. CEREP has recorded more than 400.000 user requests since it went live. Access statistics have been recorded from numerous countries, with the EU, US, Switzerland, Japan and China accounting for the highest concentration of users. CEREP users proved to have an even interest among all rating statistics provided by CEREP, with a slight preference for statistics in the *Rating Activity*, as compared to the statistics of the *Default Rates* and *Transition Matrices* screens. Access requests have been recorded on all CRAs reporting to CEREP. ESMA has responded to CEREP related queries from various market actors, including public institution officials, academics and investment banks representatives.
40. Technical enhancements have been introduced throughout the year including, in particular, more EU-focused filters and the possibility of incorporating performance data on covered bonds, as these constitute an important area of market and supervisory interest.

V. Policy and cooperation

V.1 The adoption of the four draft RTS

41. The ESMA Regulation entrusts ESMA with the development of draft Regulatory Technical Standards (RTS) to ensure a level playing field and adequate protection of investors and consumers across the Union. As provided for in Article 21(4) of the Regulation, ESMA issued four draft RTS, which covered the following areas:
- i) the information to be provided by a credit rating agency in its application for registration as set out in Annex II of the Regulation and the information that the credit rating agency must provide for the application for certification and for the assessment of its systemic importance to the financial stability or integrity of financial markets referred to in Article 5;
 - ii) the presentation of the information, including structure, format, method and period of reporting, that credit rating agencies shall make available in a central repository;
 - iii) the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3);
 - iv) the content and format of ratings data periodic reporting to be requested from the credit rating agencies for the purpose of on-going supervision by ESMA.
42. On 30 May 2012 the final versions of the RTS were published in the Official Journal of the European Union, after endorsement by the European Commission on 21 March 2012.²⁴

V.2 The Guidelines and Recommendations on the scope of the Regulation

43. In December 2012, ESMA issued a consultation paper on guidelines and recommendations on the scope of the Regulation. The draft guidelines aim to provide clarification on certain aspects of the scope of the Regulation.
44. The Consultation paper submits proposed guidelines whereby CRAs established in the EU must be registered under the Regulation in order to conduct rating activities. Certification is only allowed with regard to ratings relating to entities established or financial instruments issued in third countries. As regards the content of credit rating activities, they should include not just quantitative analysis but also sufficient qualitative analysis, according to the rating methodology established by the credit rating agency. The consultation paper then goes on to clarify that ratings distributed to a list of subscribers do not fall within the definition of private rating and are, therefore, subject to the Regulation. The paper further

²⁴ See the relevant Commission Delegated Regulations in:
<http://eur-lex.europa.eu/JOIndex.do?year=2012&serie=L&textfield2=140&Submit=Search&submit=Search&ihmlang=en>.

states that CRAs' branches located in third countries should not undertake important operational functions.

45. The consultation paper also contains specific disclosure recommendations for credit scoring entities and CRAs established in third countries. Credit scoring entities that distribute credit scores to the public in the EU are recommended to provide clear and prominent disclosure that those scores are not credit ratings issued in accordance with the Regulation.
46. ESMA will take action against any credit rating agency issuing, endorsing, or distributing credit ratings to the public, or by subscription in the EU, without being registered, or certified as appropriate, under the Regulation.

V.3 Cooperation with third countries

47. The Regulation provides two alternatives to allow credit ratings issued in third countries to be used in the EU: endorsement and certification.
48. The endorsement regime is applicable to credit ratings undertaken in whole, or in part, by the endorsing CRA or by CRAs belonging to the same group. This regime requires that the CRAs established in a third country must comply with legal requirements that are *as stringent as* those under the Regulation and are subject to effective supervision. In addition, a cooperation arrangement must be established between ESMA and the relevant third country supervisory authority. To date, credit ratings issued by CRAs based in Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, Singapore and the US can be used in the EU for regulatory purposes (see Table 1 below). These decisions mean that European financial institutions are entitled to use credit ratings issued in these countries for regulatory purposes in the EU.
49. The certification and equivalence mechanisms allow credit ratings on non-EU institutions and/or financial instruments, issued by supervised CRAs from third countries to be used for regulatory purposes in the EU, provided that the CRAs and the ratings themselves are not systemically important for the financial stability or integrity of the financial markets of one or more EU Member States.
50. In the course of the first half of 2012, ESMA submitted, upon request from the EC, its favourable technical advice concerning the eligibility of the legal and supervisory framework in the US, Canada and Australia as regards the equivalence regime. The EC adopted the equivalence decisions of the US, Canada and Australia on 5 October 2012, while Japan was recognised as equivalent in 2010.

Table 1 - Endorsement and equivalence of third countries

Country	Cooperation arrangement (MoU)	Endorsement decision by ESMA	Equivalence advice by ESMA to EC
1. US	Yes	15 March 2012	18 April 2012 Final decision by EC on 9 October 2012
2. Japan	Yes	1 June 2011	CESR advice of 21 May 2010; final decision by EC on 28 September 2010
3. Australia	Yes	21 December 2011	18 April 2012 Final decision by EC on 9 October 2012
4. Canada	Yes	15 March 2012	18 April 2012 Final decision by EC on 9 October 2012
5. Hong Kong	Yes	15 March 2012	Advice requested by EC to ESMA on 22 October 2012
6. Singapore	Yes	15 March 2012	Advice requested by EC to ESMA on 22 October 2012
7. Argentina	Yes	18 April 2012	Advice requested by EC to ESMA on 22 October 2012
8. Mexico	Yes	18 April 2012	Advice requested by EC to ESMA on 22 October 2012
9. Brazil	Yes	27 April 2012	Advice requested by EC to ESMA on 22 October 2012

51. ESMA had an active role in the work of the International Organization of Securities Commissions' (IOSCO) Committee 6 on CRAs. In particular, ESMA coordinated the consultation of the European registered CRAs during the groundwork for the revision of the IOSCO Code of Conduct for CRA activities and was actively involved in the publication by IOSCO of a consultation paper on the establishment of global colleges for the supervision of CRAs that are internationally active. Finally, ESMA contributed to IOSCO's report on internal controls and conflicts of interest within CRAs.

V.4 The impact of the CRA3 amendments on ESMA's supervisory competences

52. During 2012, ESMA followed the negotiation of the new amendments to the Regulation (the so-called CRA3 legislative package) by providing its technical feedback – when requested – to the EC, the European Parliament and to the Council. ESMA also began its planning for the implementation of the relevant provisions of the CRA3 Regulation.

53. On 27 November 2012 the European Parliament, the Council and the EC reached a final political agreement on the CRA3 legislative package (one Directive and one Regulation).²⁵ This agreement has been preliminarily ratified by ECOFIN, at Coreper level, on 3 December 2012 and was voted on in plenary by the European Parliament on 16 January 2013. Entry into force will take place 20 days after publication. The CRA3 package contains the following key features:

- i) Reducing reliance on external ratings, requiring financial institutions to strengthen their own credit risk assessment and not to rely solely and mechanically on external credit ratings. Also European Supervisory Authorities, including ESMA, should avoid references to external credit ratings and will be required to review their rules and guidelines and where appropriate, remove credit ratings where they have the potential to create mechanistic effects;
- ii) The set of provisions on sovereign ratings aim to improve transparency and include the requirement for CRAs to issue at the end of each year a calendar with the rating actions for the following year, to publish ratings after close of EU trading venues and to disclose the full research report for sovereign ratings;
- iii) The CRA3 package includes provisions on the prevention of conflicts of interest by CRAs' main shareholders;
- iv) The new rules will introduce mandatory CRA rotation for re-securitisations and will require issuers to hire a small CRA alongside one or more large ones will function on a comply-or-explain basis;
- v) ESMA has been given the task to set up and run a European rating platform which will improve transparency and comparability of credit ratings and to run a dedicated webpage of all information on the credit quality and performance of the underlying assets of structured-finance ratings to be fuelled jointly by the issuer, the originator and the sponsor. ESMA has been requested to prepare draft RTS for those two purposes;
- vi) Finally, ESMA has been given the task to supervise the fees charged by CRAs to their clients for which a draft RTS has also been requested to ESMA.

54. The CRA3 package also requires ESMA to:

- i) adopt four draft RTS by one year from the entry into force of CRA3;

²⁵ The CRA3 Regulation introduces amendments to the Regulation currently in force; the CRA3 Directive amends the EIORPS Directive (2003/41/EC), the UCITS Directive (2009/65/EC) and the AIFM Directive (2011/61/EU).

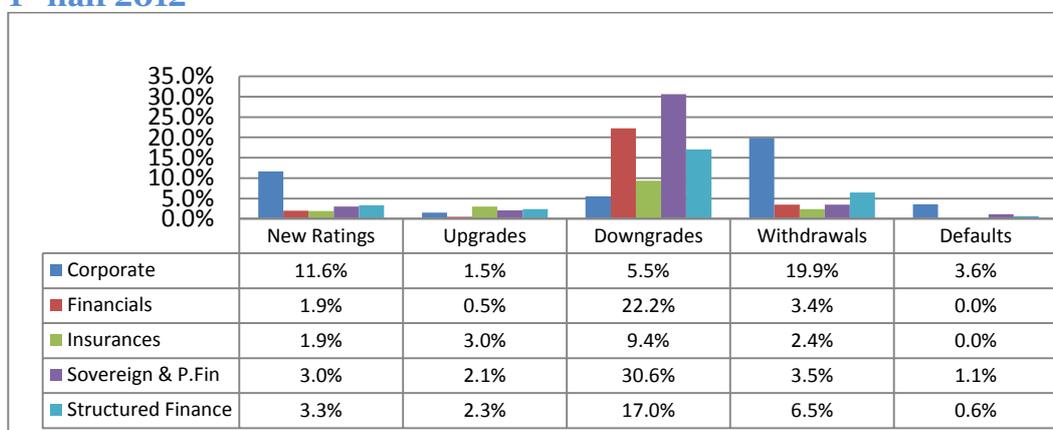
- ii) deliver technical advice to the Commission on a number of issues including network of small and medium sized rating agencies, extension of the rotation rule, alternatives to external ratings, competition in the rating industry;
- iii) report to the Parliament, the Council and the Commission on the feasibility of mapping of ratings scales and staffing and resources needs;
- iv) renew its assessments on third country endorsement by 1 June 2018 as regards some of the new provisions contained in CRA3;
- v) disclose every year to the public information on CRAs' market share.

VI. Industry trends

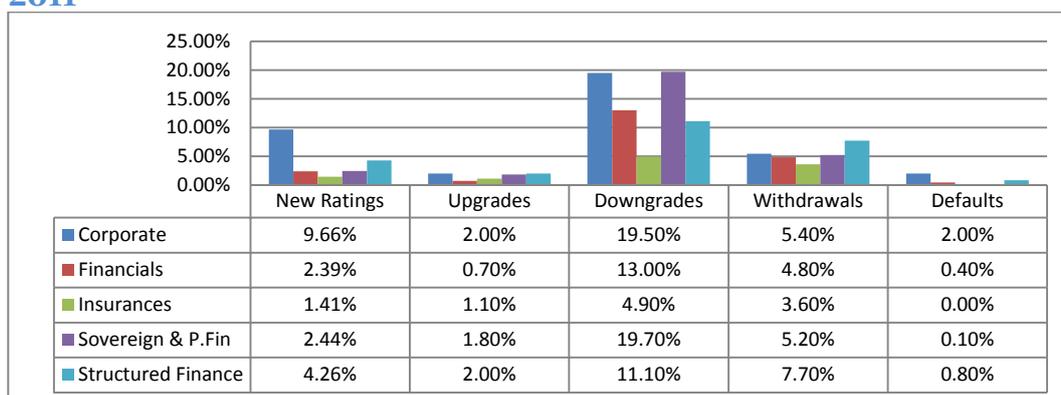
55. ESMA views CEREP as a useful instrument to monitor market trends and CRA industry trends. The figures below provide an overview of the rating activity in the EU during the first half of 2012, as well as a historical overview of rating trends, volatilities and rating distributions.²⁶ Figure 1 reviews the rating activity in the EU in the first half of 2012 and compares it to 2011 figures. Figure 2 provides information on drift (ratio between upgrades and downgrades) and volatilities of ratings in Europe from an historical perspective (2005-2012).

Figure 1 - EU rating activity 1st half 2012 and 2011 (as % of ratings outstanding)

1st half 2012



2011



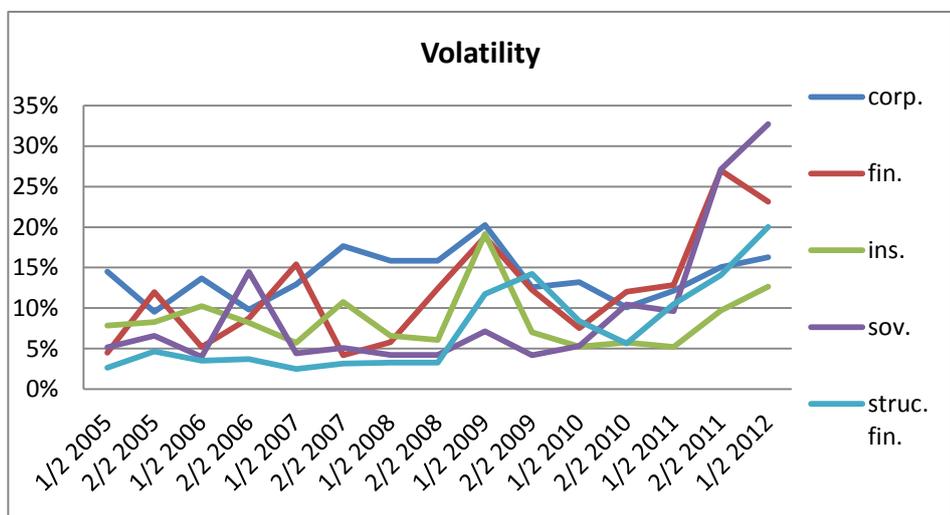
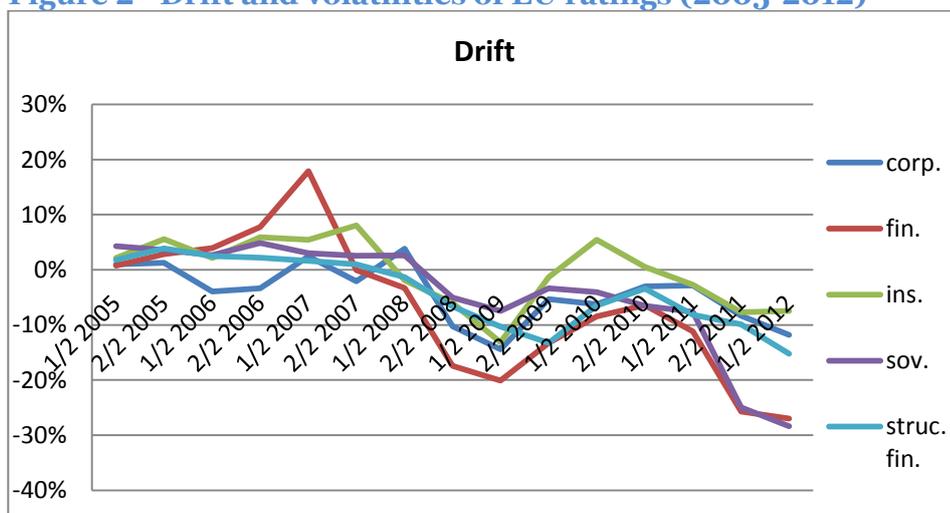
56. The first half of 2012 is characterised by a persistence of the downward tendency in rating activity. Downgrades exceeded upgrades across all asset classes reflecting the overall negative trends in economic activity in Europe.

²⁶ The information provided in this part is in accordance with Article 11(2) of the Regulation, which requires ESMA to publish summary information on the CEREP main developments on an annual basis.

57. Sovereign and public finance ratings (30.6%) suffered a dramatic amount of downgrade, even higher than the important figures registered in 2011 (19.7%), followed by financials (22.2%) and structured finance (17.0%), which also recorded increasing downgrades as compared to 2011 (13% and 11.1% respectively).

58. Defaults were registered in three asset classes – corporates, sovereigns and structured finance. The default rates were 3.6%, 1.1% and 0.6% respectively.

Figure 2 - Drift and volatilities of EU ratings (2005-2012)



59. The observed period shows significant negative trend / drift in rating actions (measured as net percentage upgrades relative to downgrades). The trends are most profound in the period between the second half of 2008 until the end of 2009 and then from the first half of 2011 until the first half of 2012. Financials and sovereigns and public finance experienced the most dramatic change while insurances were relatively most stable. The effect of the overall negative trend is a downward change in the distribution of ratings on the rating scale.

60. Volatility (defined as sum of upgrades and downgrades relative to ratings outstanding), across asset classes, peaked in the first semester of 2009 then slightly decreased in 2010, but gained on momentum again in 2011 and has been rising sharply ever since. The ultimate effect of higher volatility is higher transition rate among rating classes.

VII. Way forward

61. ESMA's decision to conduct an investigation on sovereign ratings in 2013 is based on a number of factors. These include the growth in volatility of sovereign credit ratings over the past months compared to historical trends, the importance of sovereign ratings from a credit market and financial stability perspective and the cascade impact on other rated entities and products.
62. Structured finance products have experienced the highest ratings transitions and defaults over the last years. Although new issuance volumes have sharply decreased after the crisis, the outstanding volumes remain at high levels. For these reasons, ESMA has decided to carry out specific supervisory work regarding structure finance ratings in 2013.
63. The supervisory work on sovereign and structured finance ratings will take the form of dedicated investigations that may be conducted either across a number of CRAs or as a deep-dive into a single CRA with a particularly large market presence in the rated product sector and may be accompanied by an on-site inspection.
64. Rating activity will also be used in ESMA's risk analytical framework. In carrying out its mission, ESMA aims to conduct risk-based supervision, to make timely interventions, use appropriate tools to ensure that CRAs comply with the Regulation and appropriately allocate its resources.
65. The enhancement of the integrity, transparency, responsibility, good governance and the reliability of credit ratings have been key drivers of ESMA's supervisory activities since it took over its supervisory responsibilities in July 2011. Since then, CRAs have increased their investments in human and capital resources to address regulatory requirements. ESMA has identified some progress in CRAs' activities, in particular as regards the public disclosure of methodologies and ratings, the increase of internal control resources, the closer involvement of senior management in the governance of CRAs and improved record-keeping practices.
66. At the same time, ESMA believes that CRAs have not yet sufficiently embedded all the main requirements of the Regulation into their organisations. Given the continued importance of credit ratings in the financial markets and the inherent conflicts of interest associated with commercial drivers and the business models applied in this industry, ESMA believes that further improvements in the following areas are necessary:
 - i) the consistent application and comprehensive presentation of rating methodologies;
 - ii) the empowerment and resourcing of analytical and control functions;
 - iii) the monitoring and surveillance of ratings; and
 - iv) the reliability of IT infrastructures.

ESMA will also focus on these matters as part of its supervisory work plan for 2013.

67. In this framework, an essential building block in the delivery of ESMA's supervisory mandate is the development of a thorough regime with intrusive supervision, which will encourage registered entities to embed good practices internally and to ensure that they meet the requirements of the Regulation. The CRA supervisory and policy work plan for 2013 sets ESMA's main objectives for the following year, namely high-impact and preventive supervision and continued updating of the policy framework, as well as the supervisory and policy work streams it will undertake to fulfil its new responsibilities under the CRA3 Regulation.²⁷

²⁷ See ESMA's 2013 CRA supervision and policy work plan in <http://www.esma.europa.eu/system/files/2013-87.pdf>.