



ADVICE TO ESMA

SMSG advice to ESMA on its Discussion Paper on the validation and review of Credit Rating Agencies' methodologies

I. Executive summary

The Securities and Markets Stakeholder Group is an advisory group, and we do not have the technical expertise to answer the consultation in detail. However we feel it is important that when considering the consultation responses that ESMA keeps to mind the wider context of maintaining market integrity and protecting investors and therefore make the following high level response to its Discussion Paper on the validation and review of Credit Rating Agencies' methodologies.

The validation of credit ratings cannot be considered in isolation. Any assessment must be set in context of the circumstances under which it was applied and take on-board any influence and/or bias which may have occurred as a result of the fees paid to the ratings agency for the specific rating or indeed ancillary services.

As the SMSG has stated previously we believe that the arrival of the European Ratings Platform (ERP) will greatly assist not only EMSA but interested third parties including academics and journalists in identifying possible anomalies in methodologies as well as in their application.

Checking that a methodology is valid will not in and of itself protect investors. The transparency that the ERP will provide not only on the performance of individual ratings but also on fees and fee arrangements will help highlight where and when there are problems with the application of any specific methodology.

1. Background

Many academic (1), regulatory (2) and government (3) investigations into the origins of 2008 Global Financial Crisis have identified that it was the improper application of credit rating methodologies and not the methodologies themselves which precipitated the US sub-prime mortgage backed securities debacle which set off the wider crisis.

We believe that it is important to learn this important lesson from recent financial history when seeking to ensure that the ratings issued by credit rating agencies regulated and authorised within the European Union are sound and fit for purpose.

- (1) Lawrence J. White, Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response www.stern.nyu.edu/sites/default/files/assets/documents/con_039549.pdf
- (2) The Turner Review A regulatory response to the global banking crisis www.fsa.gov.uk/pubs/other/turner_review.pdf

Council on Foreign Relations: The Credit Rating Controversy www.cfr.org/financial-crises/credit-rating-controversy/p22328
- (3) Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

2. Monitoring fees, incentives and accuracy

ESMA by necessity a risk-based regulator and cannot be expected to sign off every single rating methodology created by a CRA. Rather it should target its resources to examining methodologies which have been brought into question by either a low accuracy ratio or where the financial relationship between CRA and company seeking the rating warrant further investigation.

As stated above in the executive summary the SMSG believes that the arrival of the European Ratings Platform in July 2016 and the transparency it will bring to the practices, remuneration and performance of CRAs will be an invaluable tool in helping ESMA identify which methodologies it needs to target with its limited resources.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 22 April 2016



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