ESMA Supervision

Annual Report 2019 and Work Programme 2020

9 March 2020 | ESMA 80-199-332

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List of Acronyms

Benchmarks Regulation	Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014
CEREP	CEntral REPository of credit rating data reported by CRAs to ESMA according to Commission Delegated Regulation 448/2012 of 21 March 2012 with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority
CFTC	U.S. Commodity Futures Trading Commission
CRA Regulation	Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies as amended by Regulation (EU) 513/2011 of the European Parliament and of the Council of 11 May 2011 and Regulation (EU) 462/2013 of the European Parliament and of the Council of 21 May 2013
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/201
CSDR	Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012
EMIR	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
EMIR 2.2	Regulation (EU) 2019/2099 of the European Parliament and of the Council of 23 October 2019 amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)
ESRB	European Systemic Risk Board
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) N0 648/2012

OTC	Over-the-counter
Q&A	Questions and answers
RADAR	ESMA's credit RAtings DAta Reporting tool
SECR	Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/201
SFTR	Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012
TC-CCP	Third-country (non-EU) Central Counterparty
TC-CSD	Third-country (non-EU) Central Securities Depository
TRACE	ESMA's Access to Trade Repositories project

Executive Summary

The European Securities and Markets Authority (ESMA) is publishing jointly (i) its annual report to highlight its direct supervisory activities during 2019 regarding credit rating agencies (CRAs) and trade repositories (TRs) and (ii) its work programme to outline its main priorities in these areas for 2020. The document also sets out the work ESMA did in 2019 and will continue to do in 2020 to prepare for the new supervisory mandates conferred to it under the Securities Financing Transactions Regulation (SFTR), the Securitisation Regulation (SECR), the Benchmarks Regulation and MiFIR. The document finally outlines ESMA's activities regarding the recognition and monitoring of third-country central counterparties (TC-CCPs) and central security depositories (TC-CSDs) in 2019 and going forward into 2020.

Credit Rating Agencies

ESMA is currently supervising 27 registered and 4 certified CRAs. During 2019, ESMA registered 2 new CRAs and withdrew 3 registrations. Industry dynamics remained largely the same over the course of 2019 as the industry remains concentrated around the three large CRAs.

In 2019, one of the main priorities for ESMA related to the improvement of the quality of the rating process. In this respect, ESMA (i) concluded its investigation into the processes CRAs followed to assign credit ratings on individual debt instruments and established appropriate remedial actions; (ii) launched a thematic review on the processes CRAs follow in assigning credit ratings to collateralised loan obligations; and (iii) clarified its expectations on the minimum standards CRAs should maintain during their rating reviews.

Following the high levels of risk identified in the 2018 risk assessment for IT, information security, and internal controls, ESMA met with key staff, assessed periodic information and incidents reported by CRAs, and monitored the implementation of remedial action plans. ESMA also continued to actively monitor developments related to Brexit and had regular interactions with senior management and the independent members of the Board of Directors to understand the strategic direction and governance of CRAs.

ESMA continued its work following the publication in January 2018 of the thematic Report on fees. ESMA set out its conclusions from this work in its follow-up Report published in December 2019. The Report highlights good practices and identifies areas for improvement regarding the transparency of fees charged and the CRAs' fees setting and costs monitoring processes as well as the access and usability of credit ratings.

Following the adoption of the updated guidelines on endorsement, ESMA further engaged with CRAs that endorse credit ratings in the EU to monitor their implementation of the guidelines.

In 2019, ESMA took one enforcement decision. ESMA's Board of Supervisors found that three CRAs belonging to Fitch Group had negligently failed to comply with certain requirements of the CRA Regulation regarding conflicts of interest stemming from relationships between the shareholders of CRAs and rated entities as well as the internal controls implemented by one of the CRAs to manage those conflicts of interest. The overall fine imposed to Fitch amounted to EUR 5,132,500.

For 2020, ESMA has identified the following key priority areas for CRAs: (i) the risks in outstanding credit ratings (ii) the quality and robustness of the rating process; (iii) the development and review of methodologies; (iv) the effectiveness of IT and information security controls, including cybersecurity following up on identified concerns on the control framework CRAs have in place against cyber-attacks and on the adequacy of their business continuity plans; (v) the access and usability of credit ratings; and (vi) the effectiveness of CRAs' control environment.

Main activities of 2019 and priorities for 2020

For Credit Rating Agencies, ESMA's supervisory activities and achievements in 2019 were:

- Registration of two new CRAs;
- Identification of weaknesses in the processes CRAs followed to assign credit ratings on individual debt instruments and establishment of appropriate remedial actions;
- Thematic review into the processes CRAs follow to assign credit ratings on collateralised debt obligations;
- Clarification of expectations on the minimum standards CRAs should maintain during their rating reviews;
- Monitoring of execution of contingency plans set up by CRAs in light of Brexit;
- Monitoring of implementation of and compliance with the updated guidelines on endorsement;
- Follow-up work on thematic report on fees charged by CRAs and publication of report highlighting good practices and identifying areas for improvement regarding the transparency of fees charged and the CRAs' fees setting and costs monitoring processes as well as access and usability of credit ratings;
- Imposition of a fine of EUR 5,132,500 to three CRAs belonging to Fitch Group for negligently failing to comply with certain requirements of the CRA Regulation regarding conflicts of interest stemming from relationships between the shareholders of CRAs and rated entities as well as the internal controls implemented by one of the CRAs to manage those conflicts of interest.

For Credit Rating Agencies, ESMA has identified the following priorities for 2020:

- Proactively identify risks in outstanding credit ratings and take appropriate actions where necessary;
- Ensure that CRAs employ robust and well-structured rating processes and understand impact of new technologies on those rating processes;
- Monitor the development and review of methodologies to ensure that CRAs use methodologies that are robust, systematic, continuous and subject to validation, including back-testing;
- Engage with CRAs to address identified concerns on IT and information security controls, including cybersecurity and cloud outsourcing;
- Ensure credit ratings are accessible and usable for investors;
- Engage with CRAs to address identified concerns on the organisational aspects of their control environment that undermine the independence of control functions and enhance compliance's monitoring activities.

Trade Repositories

ESMA is currently supervising 9 registered TRs. During 2019, ESMA registered 2 new TRs and withdrew 1 registration. The TR landscape experienced an important evolution compared to previous years, with Brexit being the principal driver of the reshape currently occurring in the industry.

In 2019, ESMA carried out work on other key supervisory priorities identified through its risk assessment. The main topics identified were (i) data quality and data access by authorities; (ii) IT and system reliability; (iii) internal controls; and (iv) the strategic direction and governance of TRs.

In this respect, ESMA continued to focus on improving data quality through the Data Quality Action Plan (DQAP) by continuously developing its data-driven supervisory processes. Engaging more frequently with national competent authorities (NCAs) and other data users has also been important for identifying key issues impacting the usability of EMIR data.

Following the high levels of risk identified for IT, system reliability and internal controls, ESMA decided to conduct more targeted on-site visits and meetings with key functions and senior representatives of high-risk entities, including with Boards of Directors, for better channelling ESMA's expectations regarding these topics.

ESMA has continued its work following the publication in January 2018 of the thematic Report on fees. ESMA set out its conclusions from this work in its follow-up Report published in December 2019. The Report highlights good practices and identifies areas for improvement regarding the transparency of fees charged by TRs.

In 2019, ESMA took one enforcement decision. ESMA's Board of Supervisors found that REGIS-TR had negligently failed to put in place systems capable of providing to regulators direct and immediate access to derivatives data from the start of the EMIR reporting obligation in February 2014 to October 2016. The overall fine ESMA imposed to REGIS-TR amounted to EUR 56,000.

For 2020, ESMA has identified the following key priority areas for TRs: (i) data quality and access by authorities; (ii) IT process and system reliability; (iii) business continuity planning; (iv) and the information security function.

Main activities of 2019 and priorities for 2020

For Trade Repositories, ESMA's supervisory activities and achievements in 2019 were:

- Registration of two new TRs;
- Improving quality of data reported by TRs through the Data Quality Action Plan;
- Monitoring execution of contingency plans set up by TRs in light of Brexit;
- Ensuring correct implementation of ESMA guidelines (Portability, Position Calculation and TRACE 3 functionalities);
- Follow-up work on thematic report on fees charged by TRs and publication of report highlighting good practices and identifying areas for improvement regarding the transparency of fees charged and the TRs' fees setting and costs monitoring processes;
- Imposition of a fine of EUR 56,000 to REGIS-TR for negligently failing to put in place systems capable of providing to regulators direct and immediate access to derivatives data.

For Trade Repositories, ESMA has identified the following priorities for 2020:

- Data quality and access by authorities, with a particular focus on the Data Quality Action Plan;
- Assess/monitor internal controls around IT processes and software changes;
- Review the effectiveness of the Information Security function and of the business continuity and disaster recovery plans.

Common supervisory activities

In 2019, ESMA worked on a number of common areas of focus for CRAs and TRs. To exploit synergies that exist between the supervision of these two types of supervised entities, ESMA performed joint work on Brexit, fees and ancillary services, periodic information guidelines, and supervisory tools.

For 2020, ESMA will continue to engage with supervised entities to ensure minimal disruption on Brexit date and the end of the transition. Activities such as ensuring operationalisation of registered entities, and particularly for TRs assessing operational separation in terms of resources and IT infrastructure, will be key priorities.

New supervisory mandates

The preparatory work for the new direct supervisory mandates under SFTR and SECR gained further momentum in 2019, where discussions with (pre-) applicants continued, assessment of the first SFTR applications are on-going, and the implementation of the new supervisory frameworks are being finalised.

Third-Country CCPs & CSDs

TC-CCP recognition: Regarding TC-CCPs operating in the EU, ESMA recognises TC-CCPs initially and, subsequently, each time a TC-CCP extends its range of activities and services ESMA reviews its recognition.

ESMA also assesses whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

During 2019, ESMA continued to monitor Brexit-related developments, adjusted and updated its contingency measures for UK-based CCPs, and informed the public accordingly. In this respect, ESMA amended the recognition decisions for the three UK-based CCPs; the recognition decisions would take effect on the date following Brexit date. For 2020, ESMA will keep an important focus in its TC-CCP activity to ensure minimal disruption on Brexit date and the end of the transition.

Furthermore, EMIR 2.2 entered into force on 1 January 2020 introducing a new category of TC-CCPs, the systemically important or likely to become systemically important CCPs (Tier 2 CCPs). Those Tier 2 CCPs will be under ESMA's ongoing direct supervision whereas the Tier 1 CCPs will be subject to the currently applicable regime of recognition and on-going monitoring.

Main activities of 2019 and priorities for 2020

For TC-CCPs, ESMA's supervisory activities and achievements in 2019 were:

- Monitoring of the activities and services provided by recognised TC-CCPs in the EU;
- Data gathering on interlinkages and exposures of EU entities with those TC-CCPs;
- Data analysis of the potential risks TC-CCPs might bring to the EU;
- Contingency measures for the recognition of UK-based CCPs in a no-deal Brexit scenario.

For TC-CCPs, ESMA has identified the following priorities for 2020:

- Set-up of the new processes corresponding to EMIR 2.2 recognition;
- Reassessment of recognition decision (including for the UK-based CCPs, if necessary);
- Set-up and implementation of the new monitoring of Tier 2 CCPs;
- Monitoring of the potential risks TC-CCPs might introduce in the EU for Tier 1.

TC-CSD recognition: Under CSDR, ESMA recognises TC-CSDs that provide notary or central maintenance services in relation to financial instruments constituted under the law of a Member State or set up a branch in a Member State. A prerequisite for recognition is the adoption of an equivalence decision by the European Commission in respect of the TC-CSD's jurisdiction. So far, there have been no equivalence decisions adopted by the European Commission, except for the one with respect to the UK on 19 December 2018 (as amended on 3 April 2019).

On 4 April 2019, ESMA adopted a recognition decision with respect to the UK-based CSD which will become a TC-CSD on Brexit day. The recognition decision would apply in a no-deal Brexit scenario. In

2019, ESMA also signed the corresponding Memorandum of Understanding (MoU) with the Bank of England, the competent authority for the UK-based CSD.

In 2020, ESMA may need to adopt a new recognition decision regarding the UK-based CSD provided that the European Commission issues a new equivalence decision on the UK's regulatory framework for CSDs.

Additionally, if applicable, ESMA may need to assess the recognition applications submitted by other TC-CSDs, following the adoption by the European Commission of equivalence decisions in respect of the TC-CSDs' jurisdictions.

Main activities of 2019 and priorities for 2020

For TC-CSDs, ESMA's supervisory activities and achievements in 2019 were:

- Contingency measures for the recognition of UK-based CSDs in a no-deal Brexit scenario.

For TC-CSDs, ESMA has identified the following priorities for 2020:

- Adopting a new recognition decision regarding the UK CSD, provided that the European Commission issues a new equivalence decision on the UK's regulatory framework for CSDs;
- Monitoring the impact of Brexit on the TC-CSD regime;
- Assessment of possible recognition applications submitted by other TC-CSDs, following the adoption by the European Commission of equivalence decisions in respect of the TC-CSDs' jurisdictions.

Annual Report 2019

Credit Rating Agencies

ESMA identifies its key supervisory priorities based on the results of its annual risk assessment that considers the risk levels of each CRA as well as dynamics in the industry as a whole. While finalising its preparation for Brexit, ESMA carried out work on other key supervisory priorities, notably in the sphere of the quality of the credit rating process, where ESMA (i) concluded its issue credit ratings investigation; (ii) launched a thematic review on the processes CRAs follow in assigning credit ratings to collateralised loan obligations; and (iii) clarified its expectations on the minimum standards CRAs should maintain during their rating reviews. ESMA continued to focus on the need for CRAs to have in place sound and effective internal controls, including appropriate IT systems and controls to protect from cyber-attacks. ESMA identified concerns on the control framework that CRAs have in place against cyber-attacks and the adequacy of their business continuity plans. ESMA engaged with key functions and senior representatives of CRAs to convey its expectations and concerns. ESMA continued to carry out intensively its ongoing supervision based on information it receives both from CRAs and other stakeholders (e.g. complaints from rating users) and to perform investigatory work in order to identify and remediate deficiencies and sanction breaches of the CRA Regulation.

Industry state of play

During 2019, ESMA registered two CRAs, Inbonis SA and Beyond Ratings SAS. Beyond Ratings SAS, Moody's Investors Service EMEA Ltd and DG International Ratings SRL (previously Dagong Europe Credit Rating Srl) were deregistered following their request. As of 31 December 2019, the total number of CRAs in the EU amounts to 27 registered and 4 certified CRAs.[1]

The industry remains concentrated around three large players.[2] ESMA observes that the capacity to generate revenue and the overall operating margins are significant for the largest CRAs operating globally. The small- and medium-sized CRAs (SMCRAs, i.e. the CRAs other than the big-3 which all together have less than 10% of the total market share) do not have the same market position as the three largest CRAs and as a result do not have similar operating margins.

An important development in 2019 has been the acquisition of DBRS, the fourth in size globally-operating group of CRAs, by Morningstar, Inc., the parent company of the US-based Nationally Recognized Statistical Rating Organization (NRSRO) Morningstar Credit Ratings. The consolidation of their operations may have an impact on the competitive landscape of the industry, depending also on the business strategy the integrated entity will adopt. ESMA will actively monitor the integration of DBRS and Morningstar activities to ensure that EU operations continue to be performed with the right level of resources and independence.

Market dynamics and trends

Credit ratings outstanding: The evolution in the number of outstanding credit ratings of the four largest CRAs are shown in charts 1 and 2.

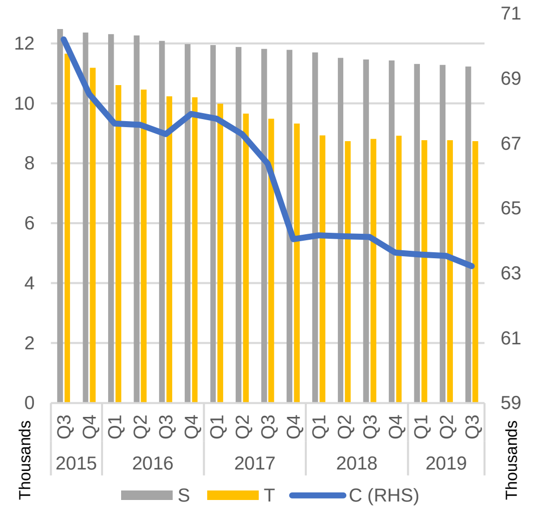
Although there has been a gradual increase in outstanding corporate issuer credit ratings, there have not been any other significant pronounced trends in this respect. As regards outstanding corporate issue credit ratings, following a gradual decrease over the period of two years, their number has remained rather stable during the past two years.

[1] https://www.esma.europa.eu/supervision/credit-rating-agencies/risk

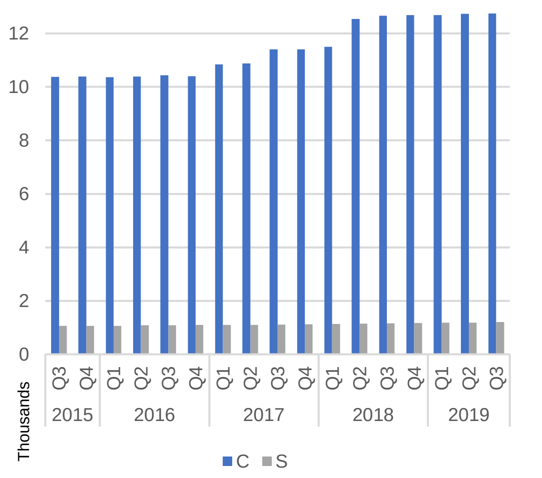
[2] https://www.esma.europa.eu/press-news/esma-news/esma-publishes-2019-cra-market-share-calculation-in-eu

Charts 1-2
Market dynamics and trend
Credit rating outstanding by asset classes

Big 4 – Issue ratings



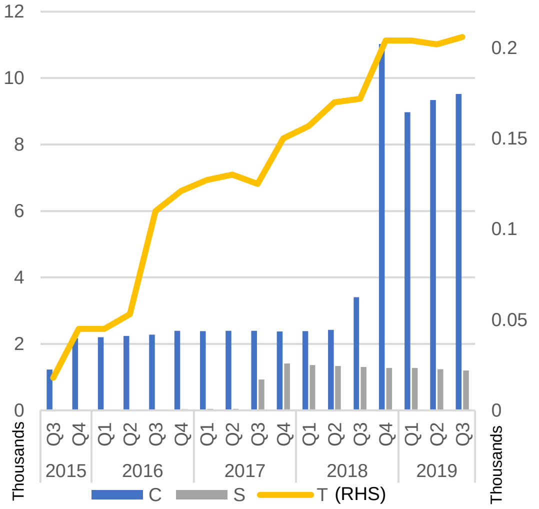
Big 4 – Issuer ratings



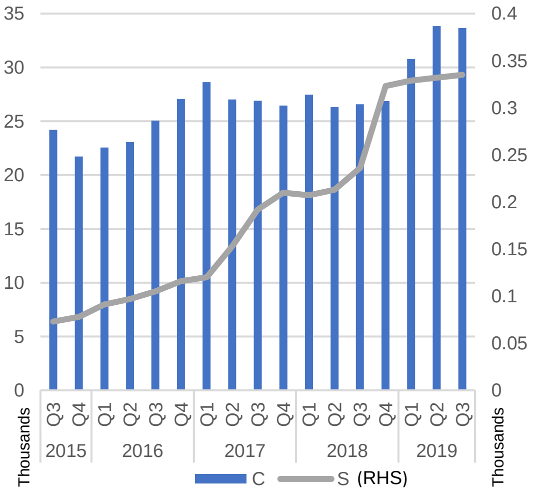
Source: ESMA RADAR database[3] 01/11/2019
Note: S(Sovereign), T (Structured finance), C (Corporate).
The credit ratings shown in these figures refer to EU credit ratings only. Corporate credit ratings include financial corporate credit ratings, non-financial corporate credit ratings and insurance undertaking credit ratings. Only for Moody's, S&P, Fitch and DBRS.

Charts 3-4
Market dynamics and trend
Credit rating outstanding by asset classes

SMCRA – Issue ratings



SMCRA – Issuer ratings



Source: ESMA RADAR database 01/11/2019
Note: S(Sovereign), T (Structured finance), C (Corporate).
The credit ratings shown in these figures refer to EU credit ratings only. Corporate credit ratings include financial corporate credit ratings, non-financial corporate credit ratings and insurance undertaking credit ratings. Only for SMCRAs.

Credit ratings issued by SMCRAs, on the other hand, have exhibited more change (see charts 3 and 4). Certain SMCRAs have adopted commercial strategies aimed at expanding their market share, notably for the purpose of being

[3] As part of its disclosure requirements, ESMA provides a unique set of data in the form of a central repository (CEREP) containing CRAs' rating activity statistics and rating performance statistics (see https://cerep.esma.europa.eu/cerep-web/homePage/displayAbout.xhtml).

recognised within the Eurosystem Credit Assessment Framework (ECAF). This has resulted in a significant increase in the number of outstanding credit ratings in certain asset classes, such as corporates and structured finance.

ESMA is monitoring on an ongoing basis these developments and may follow up if it has supervisory concerns.

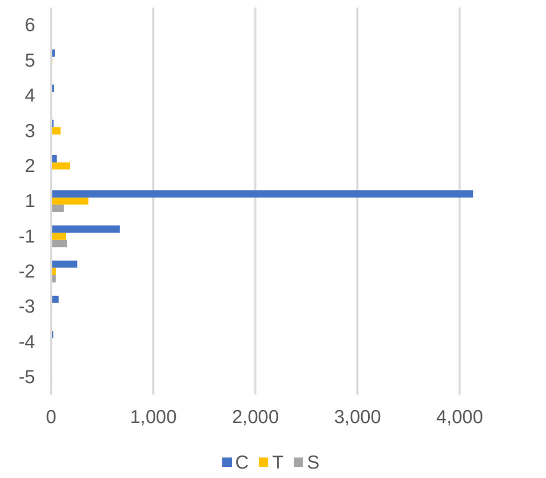
Credit rating changes: ESMA closely monitors large credit rating changes and, where necessary, follows up with CRAs as these changes may be indicative of lack of compliance with the requirements and objectives of the CRA Regulation. Large credit rating changes could, among others, be the result of an inappropriate review process of credit ratings, misapplication of the rating methodology and/or presence of conflicts of interest.

In 2019, ESMA did not observe significant credit rating upgrades or downgrades (e.g. +/- four notches and above) across asset classes. As shown in chart 5, most of the credit rating changes have been in the band of +/- two notches.

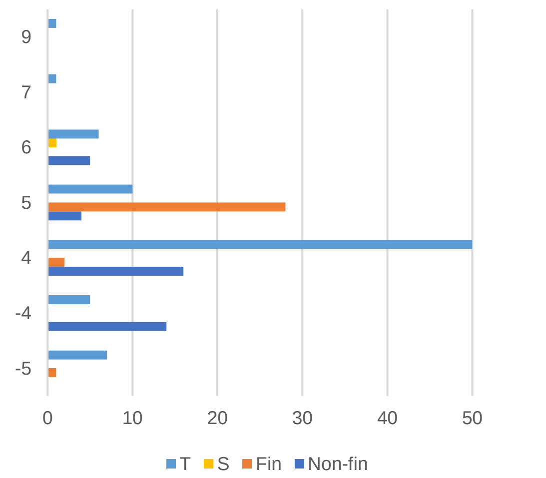
Chart 6 also sets out credit rating changes (upgrades and downgrades) on financial instruments equal to or larger than four notches. For example, securitisation credit ratings have exhibited significant upgrades. While such behaviour is partially explained by the functioning of the securitisation transactions themselves (e.g. as the securitisation bonds amortize, an increase in credit enhancement leads to rating upgrades), ESMA has also identified instances where such large credit rating changes may be the result of inappropriate monitoring of the underlying transaction by the CRAs. CRAs are required to monitor their credit ratings on an ongoing basis and review them at least annually.

Charts 5-6
Market dynamics and trend
Credit rating changes by asset classes 2019

Credit rating changes 2019



Big4-Issuance rating changes 2019



Source: ESMA RADAR database 01/11/2019
Note: S(Sovereign), T (Structured finance), C (Corporate), Fin (Corporate financial), Non-fin (Corporate non-financial)
The credit ratings shown in these figures refer to EU credit ratings only. Corporate credit ratings include financial corporate credit ratings, non-financial corporate credit ratings and insurance undertaking credit ratings.
Only for by Moody's, S&P, Fitch and DBRS.

Due to the dynamic nature of structured finance credit ratings, ongoing monitoring of the performance of all transactions is necessary to timely capture the latest changes in credit quality. Appropriate monitoring of all credit ratings is paramount to the accuracy of credit ratings and has been a key area of ESMA's focus.

The rise of BBB-rated bonds[4]: In recent years, bonds have increasingly been rated in the BBB range. As shown in charts 7 and 8, the share of outstanding corporate bonds in the EU that were rated BBB grew from 20% (3Q14) to 30% (3Q19). In volume terms, EUR 2.1tn of the EUR 7.1tn EU corporate bond debt was rated BBB by 3Q19.

Trends towards more BBB-rated bonds are also reflected in issuance, where for both corporates and sovereigns, sizeable issuance of bonds with a BBB rating has become the norm.

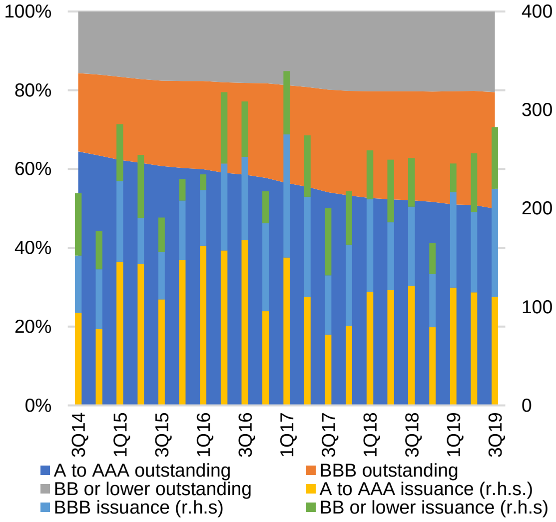
This trend emphasizes the need for CRAs to ensure high quality of their underlying credit analysis so that their credit ratings truly reflect the creditworthiness of the rated assets. In case of deteriorated macroeconomic prospects, CRAs may be forced to suddenly revise their creditworthiness assessment. In this scenario, the major investors in BBB debt, such as banks, insurers, pension funds and investment funds may be exposed to a series of downgrades of BBB-rated companies to speculative grade, which, in turn, may have a disruptive impact on the financial markets.

ESMA will maintain its supervisory focus on this trend and continue to monitor the activities of CRAs to ensure that they produce credit ratings that incorporate all available information in a timely manner and are free of conflicts of interest.

Charts 7-8

Corporate bond ratings outstanding and issuance in the EU

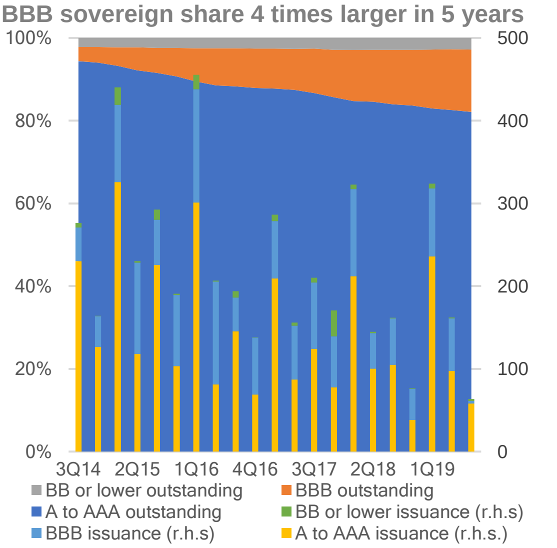
Steadily growing share of BBB-rated corporates



Source: Refinitv EIKON, ESMA.
Note: Corporate bonds outstanding shares in % and issuance in EUR bn by rating.

Sovereign bond ratings outstanding and issuance in the EU

BBB sovereign share 4 times larger in 5 years



Source: Refinitv EIKON, ESMA.
Note: Sovereign bonds outstanding shares in % and issuance in EUR bn by rating.

Leveraged loans and Collateralised Loan Obligations[5]: The leveraged loan market has been buoyant over the last few years, as investors are attracted by higher yields on these instruments when compared to investment

[4] See ESMA Report on Trends, Risks and Vulnerabilities, No 1, 2020; ESMA50-165-1040.

[5] See ESMA Annual Statistical Report, EU Alternative Investment Funds 2020 of 10 January 2020 (ESMA50-165-1032).

grade corporate bonds and corporate borrowers are able to obtain relatively cheap funding. Several authorities and international financial institutions have recently raised concerns about the rapid growth of the leveraged loan market, amid a deterioration of credit quality of corporates.

In this context, one of ESMA's key supervisory activities for 2019 has been the review of the processes and controls CRAs have in place for producing credit ratings on collateralised loan obligations and of the quality of the applicable methodological framework. Below, ESMA sets out in more detail the scope and objectives of this supervisory activity.

Key supervisory activities

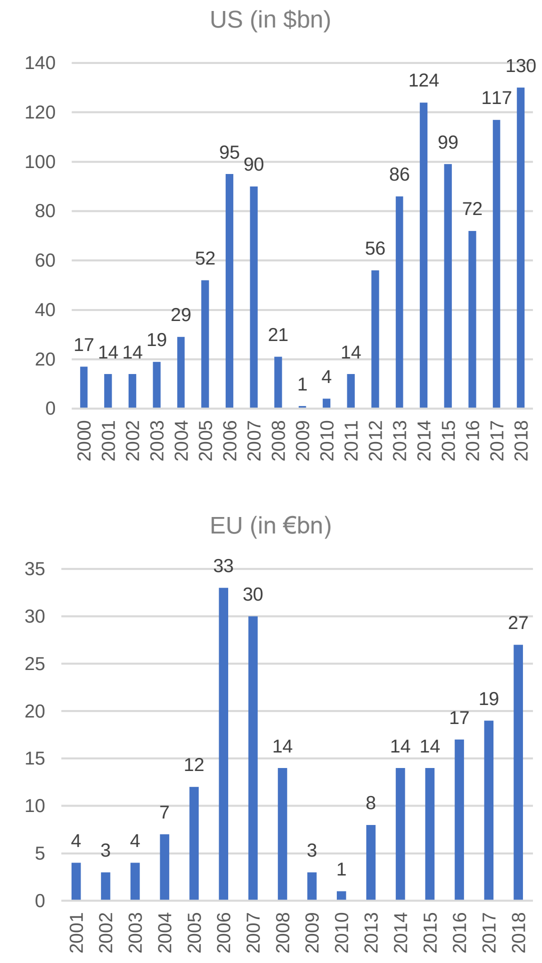
ESMA indicated in its 2019 work programme that its CRA supervision would focus on three key areas: (i) portfolio risk; (ii) quality of the credit rating process; and (iii) cybersecurity. The sections below provide an overview of the key areas of focus and the supervisory activities triggered by the CRA policy work during 2019.

Collateralised Loan Obligations (CLOs) thematic review

As indicated above, over the past years, the low interest rate context and the accommodative monetary policy conditions have contributed to further develop corporate debt markets. On the demand side, this has incentivised non-financial businesses to increase their level of debt. On the supply side, investors searching for higher yields have had a renewed appetite for riskier exposures, particularly leveraged loans (e.g. leveraged buyouts).

In this context, issuances of securitisation instruments backed by corporate loans have picked up over the past five years in both US and the EU. While EU securitisation markets have remained subdued since the subprime crisis, the issuance of CLOs is growing at a rapid pace, as shown in charts 9-10.

Charts 9-10
European and US CLO new issue supply



Source: J.P. Morgan.

Public authorities have been focusing recently on the potential resurgence of risks in leveraged loans. The Financial Stability Board and the International Monetary Fund have expressed concerns and asked public authorities to monitor this asset class and identify potential vulnerabilities. Overall, authorities and industry experts have concerns about a potential rise in default rates in leveraged loans (for instance in case of a cyclical downturn) leading to a financial shock on the financial sector, particularly through CLOs exposures.

ESMA has launched a thematic review on the process CRAs follow in assigning credit ratings to CLOs to assess how the three largest CRAs analyse and reflect risks of these instruments in their methodologies. ESMA collected background information of CLO rating practices and interacted with CRAs to better understand the CLO methodologies and their validation process.

In the coming months, ESMA will assess CRAs' compliance with the CRA Regulation and by end of April 2020 issue a report covering three main issues: (i) the use of rigorous, systematic and continuous rating methodologies for CLO instruments; (ii) the validation of CLO credit ratings methodologies; and (iii) the ongoing monitoring of CLO credit ratings including the thorough analysis of all available information.

Cybersecurity thematic review

Cyber-attacks have become a significant and highly escalating threat to investor protection, the financial markets and their stability worldwide. Hence, cybersecurity is high on the international political, regulatory and supervisory agenda. Through its ongoing supervision, ESMA became aware of several cybersecurity incidents in the industry. Consequently, ESMA identified cybersecurity as a high risk for CRAs and made it one of its main supervisory priorities for 2019.

ESMA surveyed certain CRAs – where it observed most of the incidents – with the aim to assess (i) the current state of the cybersecurity risk environment as perceived by the CRAs and (ii) the current defence mechanisms and capabilities CRAs have employed to protect their assets from cyber-attacks.

The review highlighted that CRAs consider that they operate in a complex and diverse cyber treat environment. Their risk scenarios include a broad range of cyber-attacks, cyber-attack vectors and threat agents. To mitigate these risks, CRAs reported that they have arrangements in place in areas such as governance, risk management and business continuity planning. CRAs also indicated that they have a mix of administrative, technical and management controls and are testing the effectiveness of these controls through techniques ranging from vulnerability assessments, penetration tests, audits to red-teaming tests.

The review suggested differing levels of maturity across the surveyed CRAs. ESMA notes that the CRAs who have taken an organisation-wide approach to cybersecurity demonstrated higher maturity levels during the review. ESMA's concerns relate to CRAs' governance around cybersecurity as well as the effectiveness of implemented controls. For example, ESMA is concerned about the soundness of the decision-making where the senior management and the Board members have reduced awareness of the relevant matters due to inadequate training or to an organisational set-up where information security officers do not report directly to the Board. ESMA is also concerned about the level of CRAs' ability to adequately identify and manage risks, particularly those related to outsourced activities. Finally, ESMA has concerns on the control framework that CRAs have in place to identify and recover from cyber-attacks and the adequacy of their business continuity plans.

Going forward, ESMA will continue to engage with CRAs as necessary to ensure that CRAs reach and maintain an adequate level of maturity considering their risk profile and business model. ESMA considers that this can only be achieved with full commitment and ownership of the process by the Boards and senior management of CRAs.

Issue credit ratings investigation

Issue credit ratings are linked to the credit ratings assigned to the respective issuers. Nevertheless, ESMA expects CRAs to ensure the highest level of due-diligence in the issue credit ratings process.

ESMA completed its investigation for a targeted number of CRAs into the processes they followed to assign credit ratings on individual debt instruments. The focus of the investigation was the design and implementation of the credit rating process at issuance and during the credit ratings' lifetime. ESMA also reviewed the sources of information used, and the control mechanisms employed.

ESMA identified concerns that CRAs assigned tasks that require analytical consideration (e.g. assessment of the characteristics of an issuance, application of the rating methodology to assess complex qualitative information) to non-analytical teams. ESMA also observed a lack of clarity on the roles and responsibilities of the different functions involved in the credit rating process. Furthermore, ESMA identified weaknesses in the controls that enable CRAs to effectively monitor changes to the conditions of the rated instruments and base their credit ratings on up-to-date information from reliable sources.

As a result of the investigation, the CRAs enhanced the measures for mitigating risks around their processes for assigning issue credit ratings. In particular, the CRAs adopted additional controls to ensure that the complexity of an issuance and all the relevant information is adequately taken into account. These controls will allow the CRAs to achieve: (i) a greater involvement of analytical staff in more complex issues; (ii) consistent inclusion of transaction documentation alongside third party data sources; (iii) systematic exchange of information with issuers over the life of issues; and (iv) strengthening of controls around all lines of defence for the issue credit ratings process. Since the majority of credit ratings assigned in the asset classes within the scope of the investigation (i.e. corporates and financial institutions) are issue credit ratings, ESMA believes that the enhancement of the CRAs' issue credit rating process – as a result of the investigation – will be to the benefit of investors.

Rating surveillance process

Through its ongoing supervision, ESMA identified that CRAs use different methods to perform the mandatory (semi)annual review of credit ratings. The CRA Regulation does not prescribe a specific process, nevertheless since 2018, ESMA has been interacting with a number of CRAs to address its concerns on their rating surveillance process. ESMA's focus has been on the appropriate controls the CRAs need to maintain in their rating surveillance process to safeguard the quality of the underlying analysis.

ESMA formed concerns that the analytical and decision-making framework of the rating surveillance process may not have been at the standards required to ensure that CRAs thoroughly analyse all available information and interact with rated entities before deciding on the credit ratings under review. ESMA was also concerned that during the rating review CRAs were not consistent in performing checks on conflicts of interest at the same level of those performed in the process for rating issuance. Finally, ESMA was also concerned that the result of the rating surveillance process was not always followed by a clear disclosure to the market (e.g. through a press release) which prevented investors and users of credit ratings to understand whether and when CRAs performed their rating review including the drivers behind the review decision.

Based on ESMA's feedback, some CRAs implemented a new rating surveillance process. Whatever tool CRAs use to perform the rating surveillance, ESMA expects CRAs to ensure high standards in terms of quality of credit ratings, disclosures and controls around the process. ESMA has introduced a Q&A to establish a set of minimum standards for rating surveillance, in order to ensure that CRAs involve staff of sufficient seniority and experience, perform the necessary conflicts of interest checks, encompass all aspects of their rating methodology, and take steps to be transparent towards both the rated entity and the market.[6]

Supervision of SMCRAs

ESMA's risk-based supervisory approach entails that a significant amount of resources is dedicated to the supervision of the CRAs with the biggest market share.

[6] See Q&A on the implementation of the CRA Regulation of 17 February 2020; ESMA33-5-87.

At the same time, key supervisory priorities enable ESMA to allocate appropriately resources to the supervision of SMCRAs as well.

In this respect, ESMA complements the knowledge drawn from its desk-based work (e.g. periodic information, notifications, ongoing interaction) by conducting on-site visits to SMCRAs. The results of such visits have further reinforced the need for a direct dialogue with SMCRAs to ensure their operational arrangements comply with the CRA Regulation while balancing the scale and complexity of their operations. A key challenge for these entities is to effectively implement and embed in their operations the policies and procedures they need to establish in order to be registered under the CRA Regulation.

By proactively engaging with specific CRAs, ESMA's objective is to enhance its understanding of their operations, identify key potential risks and challenges, and ensure that CRAs continue to comply with the conditions for their initial registration. ESMA also considers such visits as a tool to interact with CRAs to enable them to understand the core objectives of the CRA Regulation.

ESMA continued to engage in this manner in 2019. During on-site visits to SMCRAs, ESMA's supervisory concerns were around the appropriateness of analytical resources (e.g. analytical- and compliance-related knowledge), the effective segregation of duties (e.g. separation of commercial and analytical activities), and the monitoring of potential conflicts of interests (e.g. outsourcing of controls in CRAs of limited staff size). While ESMA appreciates the need for a proportionate application of regulatory requirements as provided for by the CRA Regulation, it expects that SMCRAs comply at all times with the conditions for their initial registration.

Enforcement

In 2019, ESMA sanctioned three CRAs belonging to Fitch Group for negligently failing to comply with certain requirements of the CRA Regulation regarding conflicts of interest stemming from relationships between the shareholders of CRAs and rated entities as well as the internal controls implemented by one of the CRAs to manage those conflicts of interest.

Specifically, Fitch infringed the CRA Regulation by: (i) having issued credit ratings on Casino Guichard-Perrachon S.A. (Casino), despite the fact that a shareholder holding more than 10% of Fitch's capital/voting rights was a board member of Casino; (ii) not having immediately assessed whether there were grounds for re-rating or withdrawing the existing credit rating on Fondation Nationale des Sciences Politiques (FNSP) because a shareholder holding more than 10% of Fitch's capital/voting rights was a board member of FNSP; (iii) not having immediately disclosed that the existing rating on FNSP was potentially affected by the fact that the shareholder was a board member of FNSP; (iv) having issued credit ratings on Renault despite the fact that a shareholder holding more than 10% of Fitch's capital/voting rights was a board member of Renault; (v) not having immediately disclosed that the existing credit ratings on Renault were potentially affected by the fact that the shareholder was a board member of Renault; and (vi) not having adequate policies and procedures as well as internal control mechanisms to ensure compliance with its obligations under the Regulation.

The overall fine ESMA imposed to Fitch amounted to EUR 5,132,500. [7]

In addition, further to a Decision of the Board of Appeal of the European Supervisory Authorities[8], ESMA's Board of Supervisors amended its decision against Nordea Bank, Svenska Handelsbanken, Swedbank, and SEB where it had found that these four banks had infringed the CRA Regulation by issuing credit

[7] See the Decisions of the ESMA Board of Supervisors for Fitch Ratings Limited UK, Fitch France S.A.S., and Fitch España S.A.U. respectively.

[8] See the Decision of the Board of Appeal of the European Supervisory Authorities.

ratings without being authorised by ESMA to do so. The amended decision of ESMA's Board of Supervisors sets out that the four banks committed the infringement without intent or negligence.[9]

Endorsement

Following the adoption of the updated guidelines on endorsement[10] in 2018, during 2019, ESMA has been monitoring their implementation by the CRAs that currently endorse credit ratings in the EU.

One of the conditions for endorsement is that the endorsing CRA is able to demonstrate to ESMA that there is an objective reason for a credit rating to be elaborated outside the EU (and endorsed in the EU).[11] The updated guidelines clarified what ESMA considers to be "objective reasons" for the purposes of this obligation. ESMA reviewed all outstanding endorsed credit ratings to ensure that endorsing CRAs continue to meet this condition.

In addition, ESMA analysed CRAs' compliance with this requirement in various scenarios of Brexit. ESMA required the UK-based CRAs to establish contingency plans to mitigate the risks of a no-deal Brexit scenario. Those contingency plans provided that, in a no-deal Brexit scenario, credit ratings that would not meet the "objective reasons" condition would be transferred from the UK to the EU27.

In the context of its Brexit-related preparation, ESMA also carried out work to ensure that two more conditions necessary for endorsement will continue to be met. In this respect, ESMA concluded that the foreseen UK legal and supervisory framework for CRAs meets the conditions for endorsement[12] and finalised a cooperation agreement with the Financial Conduct Authority (FCA), the UK's competent authority that will become the designated supervisory authority for the UK-based CRAs post-Brexit.[13]

Environmental, social, and governance (ESG) factors

In response to the European Commission's Action Plan on Financing Sustainable Growth[14], ESMA conducted an assessment of the consideration of ESG factors in credit ratings. The conclusion of this assessment was provided in a Technical Advice published on 19 July 2019.[15] The basis of ESMA's assessment was a questionnaire issued to a representative sample of CRAs in Q3 2018. The conclusion of the assessment was that while the CRAs contacted are considering E, S or G factors in their credit ratings, the extent to which each factor is considered varies by asset class, according to the importance assigned to that factor by a CRA's rating methodology for the purpose of assessing creditworthiness. As a result, while ESG considerations can be a factor, credit ratings should not be understood as providing an opinion on sustainability characteristics of an issuer or entity.

As an additional task under the Action Plan, in July 2019 ESMA published guidelines on disclosure requirements applicable to credit ratings.[16] These guidelines are intended to improve the overall quality and consistency of CRAs' credit rating press releases. In addition to a number of more general requirements, the guidelines include a specific section to improve transparency around whether ESG factors were a key driver of a credit rating action.

[9] See the amended Decisions of the ESMA Board of Supervisors for Nordea Bank, Svenska Handelsbanken, Swedbank, and SEB respectively. The Decision of the ESMA Board of Supervisors where it had found that Danske Bank had infringed the CRA Regulation by issuing credit ratings without being authorised by ESMA to do so was not amended as Danske Bank did not appeal against the Decision.

[10] Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation; 20 May 2019; ESMA33-9-282.

[11] Article 4(3)(e) of the CRA Regulation.

[12] See ESMA's Public Statement on endorsement of credit ratings elaborated in the United Kingdom in the event of a no-deal Brexit (ESMA33-5-735) of 15 March 2019.

[13] Article 4(3)(h) of the CRA Regulation; https://www.esma.europa.eu/press-news/esma-news/esma-and-eu-securities-regulators-agree-no-deal-brexit-mous-fca

[14] Action Plan: Financing Sustainable Growth, Action Point 6.

[15] Technical Advice on Sustainability Considerations in the Credit Rating Market; 18 July 2019; ESMA33-9-321.

[16] Guidelines on Disclosure Requirements Applicable to Credit Ratings; 18 July 2019; ESMA33-9-320.

Trade Repositories

Preparing the industry for Brexit has been one of ESMA's key priorities and in 2019 ESMA dedicated substantial resources to ensure that UK-based TRs wishing to continue operating in the EU27 can do so in any Brexit scenario. At the same time, ESMA carried out work on other key supervisory priorities, identified through its risk assessment, in particular on data quality, IT and system reliability, and TRs governance. ESMA continued to focus on improving data quality by developing new data-driven supervisory processes, engaging more frequently with national competent authorities (NCAs) and other data users to take stock of the most material issues impacting the usability of EMIR data, and meeting with key functions and senior representatives of high-risk entities, including with Boards of Directors. In this respect, the more targeted on-site visits have proven to be effective for channelling ESMA's expectations regarding IT and system reliability, internal controls, and the compliance culture in general.

Industry state of play

The TR landscape in Europe experienced an important evolution compared to previous years. Brexit continues to be the principal driver of the reshape currently occurring in the industry. Throughout 2019, ESMA has been engaging with the industry to ensure minimal disruption on Brexit date.

In 2019, two EU-27 entities affiliated to two of the four UK-based TRs submitted their applications for registration to ESMA as part of their contingency plan to continue operating in the EU27 after Brexit. DTCC Data Repository Plc. was the first to receive approval from ESMA to launch its EU27 TR operation from Ireland, shortly followed by UnaVista TRADEcho B.V., who opted to establish its EU27 TR in the Netherlands.

On 2 November 2018, CME Group announced that it had finalised the acquisition of NEX Group, including the Sweden-based NEX Abide Trade Repository (NATR). This acquisition allowed CME Group to establish its presence in the EU27.

Bloomberg Trade Repository Limited (BTRL) became the first TR that decided to renounce its registration. The withdrawal became effective on 1 March 2019 after ensuring that all BTRL clients were transferred to an active TR of their choice.

As of 31 December 2019, nine TRs are registered by ESMA in the EU.[17]

Looking ahead, SFTR will certainly have an impact on the TR landscape, as it allows for a simplified process for extension of registration for EMIR-registered TRs.

Market dynamics and trends

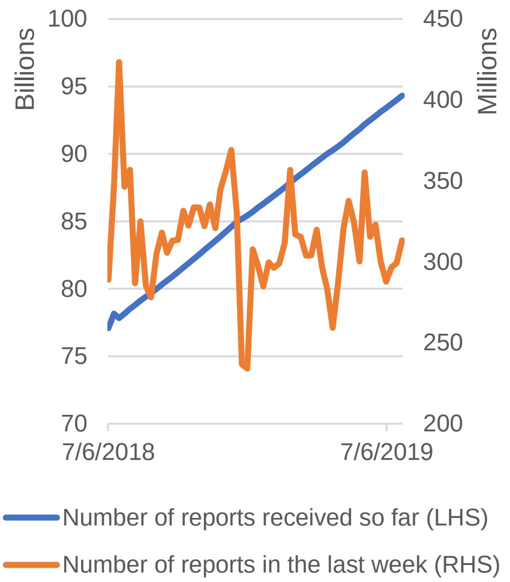
TRs continue to play a central role in enhancing the transparency of derivatives markets and reducing risks to financial stability.

Since the EMIR reporting start date back in 2014, the industry has collected nearly 95bn derivatives reports in total. In 2019, on average, TRs collected 300m reports each week (Chart 11).

These highly granular reports contain up to 129 fields populated with information about the constituent of a derivative transaction, such as counterparty information, type of product, maturity, underlying instrument(s), notional, valuation and collateral updates as well as other lifecycle events that can occur from inception to maturity.

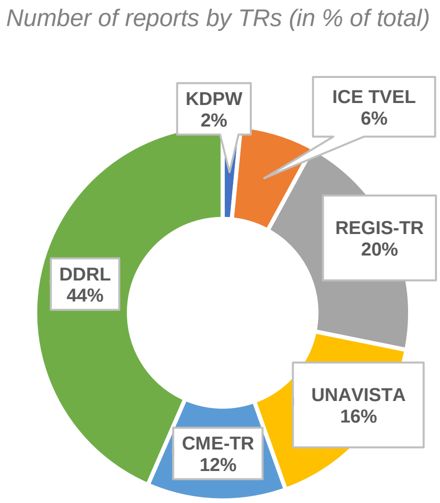
[17] https://www.esma.europa.eu/supervision/trade-repositories/list-registered-trade-repositories

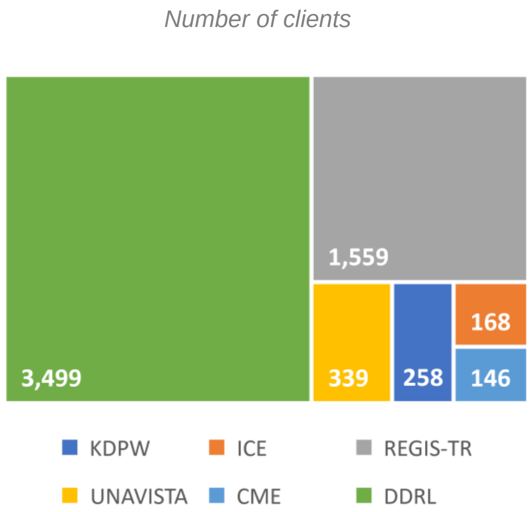
Chart 11
Weekly volumes and total number of EMIR reports
300mn reports submitted on average each week



Source: ESMA calculations based on weekly statistics reports (26/07/2019) provided by TRs.

Charts 12-13
Market share indicators
DDRL and REGIS-TR largest EU TRs





Note: BTRL and NATR are not included in the aggregation as number of reports submitted to these TRs are relatively small compared to the rest.
Source: ESMA calculations based on weekly statistics reports (26/07/2019) provided by TRs.

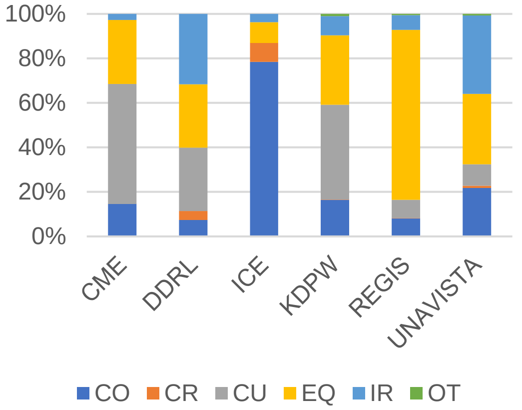
Since 2014, around two-thirds (64%) of the reports submitted so far to TRs have been routed via DDRL or REGIS-TR (Chart 12). The remaining share is mainly divided between UnaVista (16%), CME Trade Repository Ltd (12%) and ICE Trade Vault Europe Ltd (6%). BTRL and NATR are not included in the aggregation, as the number of reports submitted to these TRs are relatively small compared to the rest.

The number of clients served by TRs has grown to nearly 6,000 (Chart 13). Around 85% of these clients are using DDRL or REGIS-TR for EMIR reporting activity.

Based on the number of outstanding trades, there are differences across TRs in terms of what kinds of asset classes are most frequently traded by their clients and whether these products are exchange-traded (ETD) or Over-the-Counter (OTC) (Chart 14).

For example, CME, DDRL, KDPW and UnaVista have a larger share of outstanding OTC trades compared to ICE and REGIS-TR. Moreover, the split by asset class reveals that ICE and REGIS-TR are quite specialised in commodity derivatives and equity derivatives, respectively (Chart 15). The fact that most of the TRs are part of market infrastructure groups, where a derivatives exchange and/or a CCP exists[18], could explain why certain TRs are specialised on certain segments of the derivatives market.

Chart 14-15
Share of outstanding trades
ETD vs OTC and by asset classes



Source: ESMA calculations based on public data reports (26/07/2019) downloaded from TRs' website.
Note: CO (Commodity), CR (Credit), CU (Currency), EQ (Equity), IR (Interest rates), OT (Other).

Key supervisory activities

Data quality

Authorities[19] rely on TRs to provide them with access to data of adequate quality so that they can monitor the derivatives markets in order to fulfil their respective mandates.

Data Quality Action Plan (DQAP): Considering the many hurdles related to the high volume, velocity and variety of EMIR data, the DQAP is a major project that NCAs and ESMA launched jointly in September 2014 to improve the quality and usability of data reported to and by TRs. The DQAP sets out the key themes ESMA will focus on along the year.

ESMA together with NCAs, central banks and other data users are making steady progress in operationalising the multi-usage of EMIR data for micro- and macroprudential supervisory activities, risk analysis related to concentration and accumulation of exposures, counterparty interconnectivity and network structure, market abuse, as well as other bespoke analysis of financial stability risks.

In line with the priorities set out in the DQAP 2019, ESMA focused its work primarily in the areas of: (i) enhancement of the re-validation process for data received and distributed by the TRs; (ii) development of automated process to assess pairing and matching rates for reconciliation; (iii) assessment of the implementation of the guidelines on portability; (iv) development of a standardised process to assess access filtering for authorities; (v) monitoring of the implementation of additional reports (e.g. Position Calculation); (vi) enhancement of the information exchange with data users by increased presence in relevant fora.

ESMA continued to monitor the data received from TRs via the data quality dashboard developed in previous years. The dashboard is updated on a monthly basis and summarises statistics that indicate the level of data quality across different dimensions. This overview allows for the identification of data quality trends and persistent issues that would not otherwise have been discovered.

For example, ESMA observed that changes to the reporting requirements that occurred in 2015 and 2017 (i.e. revised Level 2 validations and amendment to EMIR TS requirements) drove up

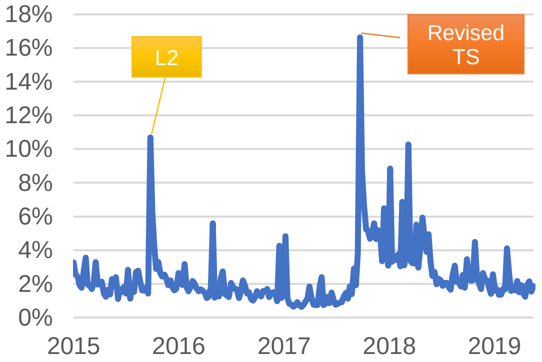
[18] For example, REGIS-TR (BME Group and Deutsche Börse Group), UnaVista (LSE Group), CME (CME Group), ICE (ICE Group), and KDPW (KDPW Group).

[19] Authorities mean any of the entities referred to in Article 81(3) of EMIR.

the average rate of reports rejected by TRs (Chart 16).

The collected statistics show that a transition period post-implementation occurred before rejection rates fell back to more acceptable levels. In this respect, TRs are responsible to inform their clients when misreporting occurs and instruct them to resend the reports using the correct format.

Chart 16
Percentage of reports rejected by TRs
Spikes in rejection rates linked to changes in reporting rules



Source: ESMA calculations based on rejection statistics provided by TRs.

ESMA monitors data quality by using its own algorithm that validates data received by TRs to verify that TRs are applying correctly the validation rules. This IT tool was further enhanced in 2019 to consume XML data from ESMA's TRACE hub.[20] The fields that are usually incorrectly populated or left blank are "valuation type", "collateral portfolio code" and "price/rate".

Peer-Review: In 2019, together with other six NCAs, ESMA voluntarily participated in the "*Peer review into supervisory actions aiming at enhancing the quality of data reported under EMIR*" [21]

The peer review's conclusion was that ESMA broadly meets the expectations in terms of (i) its overall supervisory approach and integration of EMIR data within its organisation and (ii) accessing and analysing EMIR data. It also acknowledged that ESMA has a sophisticated dashboard which through a wide variety of filters enables a detailed analysis and visualisation of data. In terms of improvements needed, the peer review recommended that ESMA improve the frequency and extent of its communication to NCAs.

NCA Framework: Since 2016, ESMA maintains a data quality log, where users of EMIR data report data quality issues. The objective is to enhance the effective use of data and prioritise data quality issues accordingly.

This standardised process prevents the replication of effort from several users of EMIR data that may try to resolve similar data quality issues. The data log also provides clarity to the EMIR data users as to why certain issues are getting priority. ESMA assesses and prioritises reported issues, and subsequently communicates the list of prioritised issues to NCAs and other data users, to allow for increased transparency of all outstanding issues.

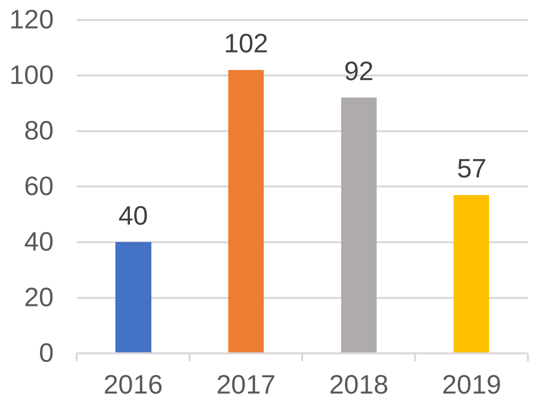
In 2019, ESMA continued to assess, prioritise, and address a wide variety of data quality issues through supervisory actions in accordance with their importance, including among others issues related to access to current and historical data, various type of errors in regulatory reports due to incorrect XML schema data validation, outliers caused by misreporting, filtering errors, issues with trade reconciliation. Understanding the root causes of issues and liaising with the TRs for a swift remediation, has been a key priority for ESMA and has been embedded in its risk-based supervisory approach.

By end of December 2019, the number of reported issues were 57, a decrease compared to the previous two years (Chart 17).

[20] In 2016, ESMA developed TRACE, an IT system that allows NCAs to have a single point of access to the data stored by TRs under EMIR.

[21] See Final Report on peer review into supervisory actions aiming at enhancing the quality of data reported under EMIR; 17 October 2019; ESMA42-111-4895.

Chart 17
Number of data quality issues reported per year
Number of issues have decreased since 2017



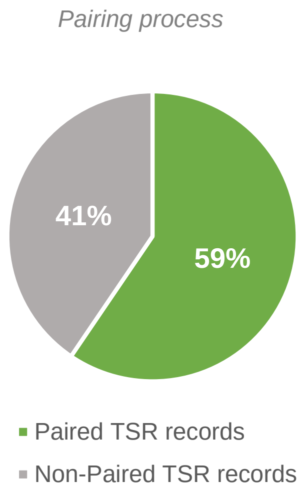
Source: ESMA calculations based on NCA framework statistics (31/12/2019).

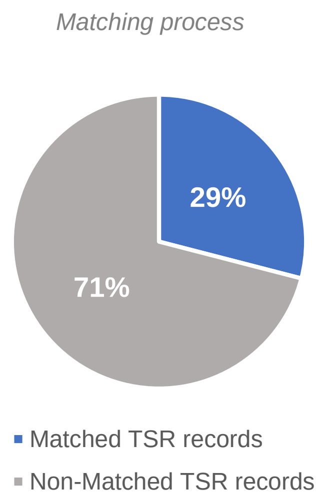
Reconciliation process: Due to the double-sided reporting obligation[22] introduced by EMIR, the inter-/intra-TR reconciliation of reported trades is one of the key data quality processes. Since the EMIR reporting start date, the results of reconciliation have been highlighting the overall low levels of agreement between the two counterparties on the details that are to be reported. Even though improvements have been made, the overall levels of pairing[23] are approximately at 60% (Charts 18-19).

Based on the analysis, the relatively low rates of pairing are mainly caused by the lack of an agreement between the two counterparties on: (i) the construct of the Unique Trade Identification (UTI); (ii) the position vs trade level reporting; and (iii) the reporting obligation.

Trade matching[24] currently stands at approximately 30%. The matching process is much more complex than pairing since many more fields are included in the comparison between the two reported legs of the same trade. The overall rate provides further evidence to the low levels of agreement between counterparties on the reportable details of the trades.

Charts 18-19
Reconciliation process
Pairing and matching level (%)





Note: The results are based on counting both sides of the trade i.e. counting records of Trade State report.
Source: ESMA calculation based on EMIR Trade State reports of 9 August 2019.

Following an in-depth analysis of the non-matching fields, ESMA identified that many of the fundamental fields of each reportable trade (such as relevant timestamps, contract type, asset class and product IDs) are the most problematic fields in the matching process (Chart 20).

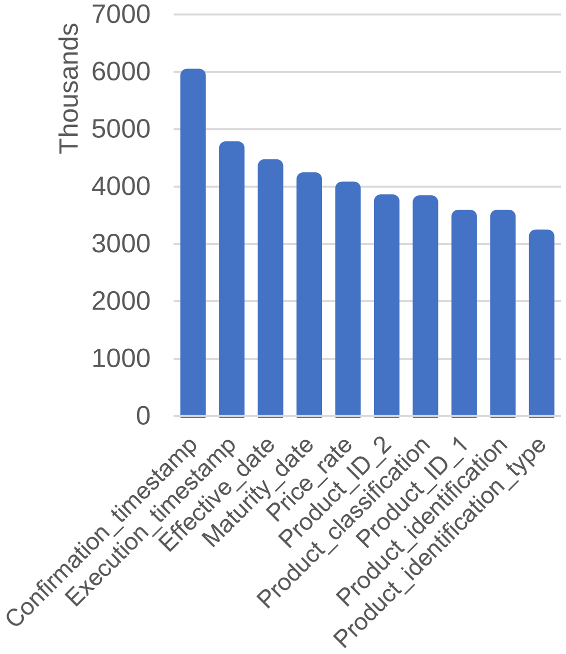
ESMA considers successful reconciliation as a gateway to high quality of EMIR data. ESMA has been working with the NCAs and TRs to

[22] Double-sided reporting obligation means that details of a trade are reported separately by each of the counterparties.
[23] A trade is considered paired if CP1-CP2-UTI of the first leg is equal to CP2-CP1-UTI of the second leg.

[24] Trade matching refers to the process of comparing EMIR reportable fields. Some EMIR fields are excluded from reconciliation since two counterparties are not expected to populate such fields with matching information.

increase the current levels of pairing and matching.

Chart 20
Reconciliation process
Top 10 breaking fields



Source: ESMA calculation based on EMIR Trade State reports of 9 August 2019

Implementation of ESMA guidelines

Portability: The guidelines on transfer of data between TRs[25] were successfully implemented in 2019 across the industry. The guidelines set out the basis to allow for a competitive TR environment and ensure high quality data is available to authorities. They also establish a consistent and harmonised process to transfer records from one TR to another and support the continuity of reporting and reconciliation in all cases, including the withdrawal of registration of a TR.

ESMA closely monitored porting activities performed between TRs due to Brexit or other reasons to ensure that TRs had followed the guidelines. In 2019, there were around 90 porting cases concluded.

Position calculation: Since the beginning of the year, ESMA has been regularly interacting with the TRs in order to monitor their progress in the implementation of the position calculation guidelines[26] and additional TRACE functionality (i.e. Position calculation, reconciliation and rejection reports) as well as to discuss with them any identified issues, risks or project delays.

In preparation for the go-live date of 4 July 2019, ESMA asked TRs to provide their business requirements and technical specifications that had been used to implement the position calculation functionality and the specific controls that they had introduced in their systems and processes to ensure compliance with the respective guidelines. Diverse level and nature of controls have been used by different TRs depending on their system architecture and design but also their IT process model. The respective technical specifications also revealed inconsistent implementation of specific requirements in the guidelines which ESMA further explores in terms of outcome similarity and adequacy.

IT incidents & system reliability

IT incidents: Since the EMIR reporting start date (2014), ESMA has established an incident notification process that sets the framework of how and by when TRs are expected to report incidents.

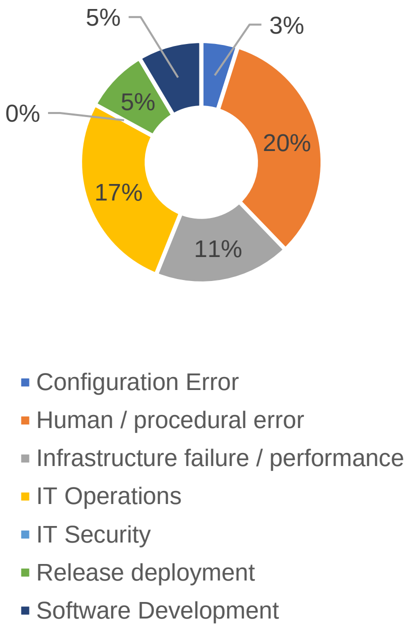
Reported incidents provide information about the incident's root cause and impact, the occurrence/discovery and resolution dates and time as well as the specific actions undertaken to permanently resolve the issue.

The information collected through the incident reporting process is instrumental to understand TRs processes, systems and internal controls in place and, consequently, to mitigate operational and regulatory compliance risks.

[25] See Final Report, Guidelines on transfer of data between TRs; 24 August 2017; ESMA70-151-552.

[26] See Final Report, Guidelines for position calculation by TRs under EMIR; 27 March 2018; ESMA70-151-1272.

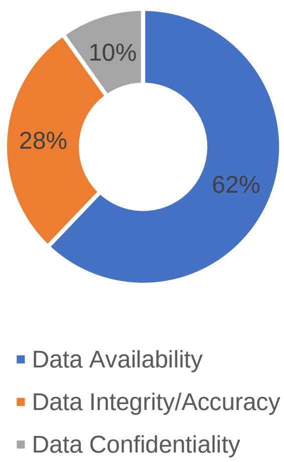
Chart 21
IT Incidents 2018-2019
Root cause as assessed by ESMA



Source: ESMA calculation based on incident statistics.

Most frequent incidents occur due to procedural or human errors and issues arising from specific IT Operations (e.g. maintenance, changes, job failures) (Chart 21).

Chart 22
IT Incidents 2018-2019
Impact type assessed by ESMA



Source: ESMA calculation based on incident statistics.

More than two-thirds of the reported incidents have had an impact on the availability of derivatives details to EMIR data users (Chart 22). ESMA pointed out specific weaknesses in the internal control system of the respective TRs, engaged with them, requested remediation actions to be undertaken and monitored progress against them.

Governance

Impactful and repetitive incidents and data quality issues may indicate an overall weak internal control environment either at process (e.g. IT system change management) or entity level (e.g. business and control functions). In addition, inappropriate governance structures may further undermine a TR's operations.

In 2019, ESMA focused on governance aspects of several TRs. Overall, ESMA identified concerns that Boards of Directors prioritise client-driven and commercial initiatives and do not pay enough attention to incidents and operational issues. In addition, ESMA is concerned on the level of attention the senior management and Boards of Directors pay to the quality of service delivery against their own intra-group outsourcing agreements, which may lead to insufficient resources being assigned by the service provider[27] to TR projects and issues resolution.

ESMA expects that, through appropriate service level agreements and service level monitoring, TRs ensure that their service providers assign appropriate level of priority and of resources so that TRs comply at all times with the conditions of their initial registration. ESMA also expects that the senior management and the Board of Directors consider high data quality and high degree of operational reliability (both from the perspective of reporting participants as well as NCAs) as one of the key areas of their focus.

ESMA had several exchanges on both strategic and operational matters with senior management and the Board of Directors.

Many of these discussions have proven to be effective and led to TRs' taking concrete measures to improve their governance structure, including among others organisational

[27] TRs typically outsource all core IT-related services to group functions.

restructuring, insourcing key functions from the group, and establishing technical committees to better deal with data and IT issues. ESMA will continue to monitor and assess the effectiveness of the decision-making at senior management and Board of Directors level.

Throughout 2019, ESMA also continued to proactively engage with TRs to understand and assess their strategic direction and governance, particularly in the context of the UK's decision to withdraw from the EU and any related changes.

Enforcement

In 2019, ESMA sanctioned REGIS-TR for negligently failing to put in place systems capable of providing to regulators direct and immediate access to derivatives data from the start of the EMIR reporting obligation in February 2014 to October 2016.

These access failures related to:

- 85.5% (3.7 billion) of REGIS-TR's data on trade terminations and 1.6% (15 million) of data on trade modifications; and
- 100% (2.9 billion) of REGIS-TR's data on trade valuations and 100% (22 million) of data on collateral updates.

The overall fine ESMA imposed to REGIS-TR amounted to EUR 56,000.[28]

[28] See the Decision of the ESMA Board of Supervisors.

Common Supervisory Activities

As identified in its supervision work programme 2019, ESMA has been working on a number of common areas of focus for CRAs and TRs. To exploit synergies that exist between the supervision of these two types of supervised entities, ESMA has performed joint work on Brexit, fees and ancillary services, periodic information guidelines, and supervisory tools.

Brexit

Currently, ESMA supervises the following CRAs and TRs established in the UK: AM Best Europe-Rating Services Ltd., DBRS Ratings Limited, Fitch Ratings Limited, Fitch Ratings CIS Limited, Moody's Investors Service Ltd, The Economist Intelligence Unit Ltd (EIU), DDRL, UnaVista, CME, ICE.

Already during 2018, the majority of the UK CRAs and TRs expressed their intention to continue providing their services in the EU27 after Brexit and have implemented subsequent actions, including applications to register new legal entities in the EU27 and material changes concerning the organisation of the entities already registered in the EU27, (e.g. to strengthen the presence of staff in the EU27).

At the end of 2018, ESMA registered two CRAs, DBRS Ratings GmbH and A.M. Best (EU) Rating Services B.V, both established in order to ensure continuity of rating services from DBRS and AM Best in the EU27. In addition, as mentioned above, in March 2019, ESMA registered two new TRs, DTCC Data Repository (Ireland) Plc and UnaVista TRADEcho B.V.

During 2019, ESMA monitored the full implementation of the supervised entities' contingency plans and finalised the pending actions to ensure that there would be no market disruption in both the CRA and TR industries. Two key principles underpinned ESMA's assessment: (i) Brexit should not lead to letter-box registered entities in the EU27 and to situations where most substantial activities/functions are conducted/established outside the EU27; and (ii) supervised entities established in the EU27 should have appropriate resources in the EU27 as well as adequate and effective governance arrangements and internal controls for the day-to-day management of their business.

ESMA also monitored the implementation of the final steps to ensure that, in a no-deal Brexit scenario, UK-based CRAs, part of a group that includes EU27 CRAs, can issue credit ratings that can be endorsed by the EU27 CRAs of the group in the EU27. In particular, ESMA concluded that the foreseen UK legal and supervisory framework for CRAs meets the conditions for endorsement (if it has fully entered into force on the date of Brexit in unaltered form) and finalised a cooperation agreement with the UK supervisory authority.[29]

Under the terms of the Withdrawal Agreement, EU law will continue to apply to the UK until 31 December 2020 as if it were a Member State.

As regards the UK-based CRAs – except for EIU – all are part of a group of CRAs with legal entities established in EU27. This will allow them to operate in EU27 and to endorse credit ratings from the UK entity at the end of the transition period.

With reference to TRs, there are currently five TRs registered and operating in EU27. ESMA will focus its supervisory effort to ensure that supervised entities have fully implemented their Brexit contingency plans so that EU27 counterparties, currently reporting to UK-based TRs, complete the transfer of their data to an EU27 TR in due time before the end of the transition period.

[29] https://www.esma.europa.eu/sites/default/files/library/esma33-5-735_public_statement.pdf

Reports on fees charged by CRAs and TRs

ESMA has continued its work following the publication in January 2018 of the Thematic Report on fees where ESMA identified its supervisory concerns and clarified its expectations in the areas of transparency and disclosure to clients of fee-related information, fee setting and costs monitoring.[30]

In December 2019, ESMA published a Follow-up Report on fees charged by CRAs and TRs[31]. The Follow-up Report examines developments in industry practices following the publication of the Thematic Report and highlights improvements and good practices that have been implemented in the area of transparency, cost monitoring and fee setting as well as interaction with related entities. ESMA sees the opportunity for all CRAs and TRs to consider how to implement the good practices identified, to enhance the standards adopted at industry level. At the same time, while recognising some positive developments, ESMA also identified areas where further improvements were needed to ensure compliance with the fees-related provisions of the CRA Regulation and EMIR. This relates notably to cost recording and monitoring and, specifically for CRAs, the access and usability of ratings, including interaction with related entities.

On the latter topic, in 2019, ESMA continued its engagement with both supervised entities and users of ratings. In response to ESMA's concerns about access to and use of ratings, the three largest CRAs implemented changes to the terms of use of credit ratings published on their websites in order to allow credit ratings to be used for regulatory reporting purposes. Furthermore, ESMA observed that one of those CRAs additionally allows the use of credit ratings for internal business purposes, which ESMA considers a better practice. ESMA will monitor the implementation of these changes and assess their impact on the users of credit ratings and, as needed, will consider whether and what additional actions can be taken to facilitate access and usability of credit ratings by investors.

Guidelines on the submission of periodic information

In July 2019, CRAs submitted to ESMA a full round of periodic information under the updated guidelines. The objective of the updated guidelines is to adjust both the content and frequency of CRAs' reporting to ESMA's risk-based supervision as well as to enable ESMA to enhance its processes with respect to new requirements (e.g. endorsement guidelines).

The new format has allowed ESMA to process in a more structured and efficient way the information that is needed to carry out its supervision. It has also enhanced comparability across the industry.

The content and format of periodic reports and ad-hoc notifications will also become more aligned across TRs. ESMA proposed guidelines containing reporting schedules, calendars and templates for TRs and launched a consultation on 27 May 2019.[32] The consultation period ended on 27 August 2019 and ESMA is currently analysing the feedback it received and finalising the proposed guidelines. The guidelines will facilitate a more consistent and more efficient supervision of TRs by streamlining the collection and processing of information.

Supervisory tools

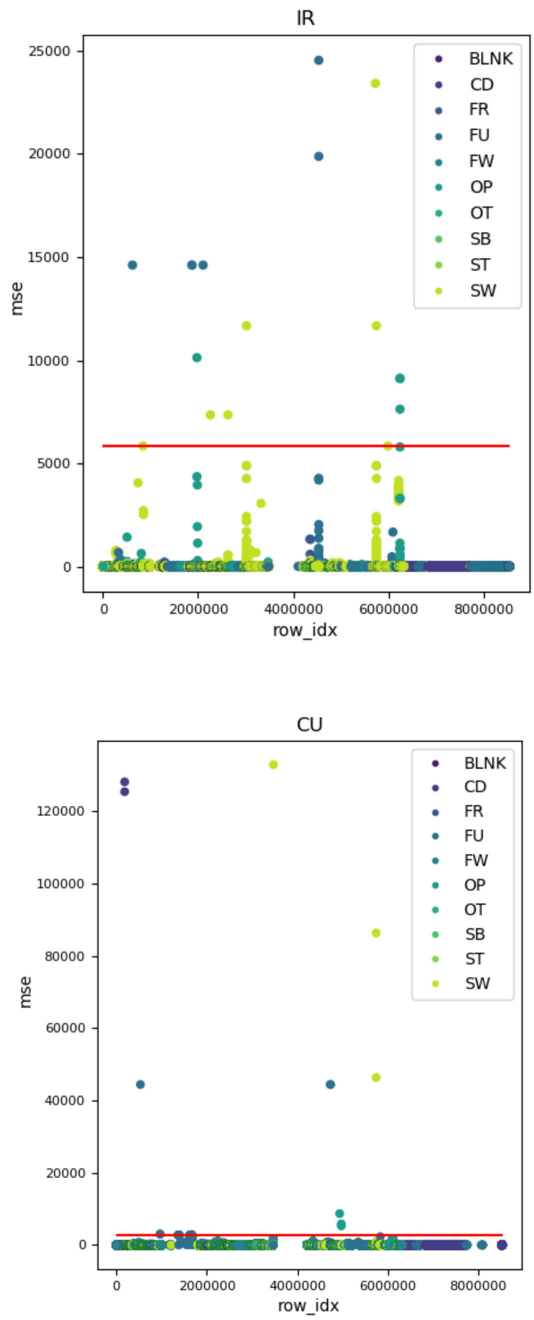
In October 2019, ESMA used a new risk management tool for the annual risk assessment. By implementing this new tool, ESMA made another step in centralising its supervisory information and in handling the information submitted by supervised entities in a more efficient and structured manner. In

[30] See ESMA Thematic Report On fees charged by Credit Rating Agencies and Trade Repositories; 11 January 2018; ESMA80-196-954.
[31] See ESMA Follow-up Report to the Thematic Report On fees charged by Credit Rating Agencies and Trade Repositories; 20 December 2019; ESMA80-196-3218.
[32] See Consultation Paper on Guidelines on periodic information and notification of material changes to be submitted to ESMA by Trade Repositories; 23 May 2019; ESMA70-145-1145.

2020, ESMA expects to improve the transmission mechanism for some ad-hoc and periodic information submitted by supervised entities with the objective of enhancing the timely and effective response to supervisory events.

For its TR supervision, ESMA continues to implement Artificial Intelligence (AI) solutions to significantly improve the processes it uses to identify data quality issues. By using machine learning techniques and neural networks, ESMA has been able to identify point, collective and contextual anomalies in Public Data and Trade State Reports. Chart 23 provides an example of identified contextual outliers over a set threshold by asset class (individual subplots) and contract type (colour scheme within each individual subplot) in a TR's Trade State report. ESMA also intends to assess potential applications to CRA data (e.g. by performing outlier detection in credit rating data).

Chart 23
Supervisory IA tools
Outliers detection in TSR per asset class and contract type



Source: ESMA calculation based on EMIR Trade State reports (TSR) of 9 August 2019

New supervisory mandates

The preparatory work for the new direct supervisory mandates under SFTR and SECR also gained further momentum in 2019, where discussions with (pre-) applicants continued, assessment of the first SFTR applications are on-going and the implementation of the new supervisory frameworks are being finalised. ESMA will also start preparatory work for its new responsibilities under the Benchmarks Regulation and data reporting service providers under MiFIR.

Securities Financing Transactions Regulation

SFTR aims to increase the transparency of securities financing transactions (SFTs). The SFTR will require both financial and non-financial market participants to report details of their SFTs to an approved EU TR. These details will include the relevant terms of the repo, stock or margin loan, the composition of the collateral, whether the collateral is available for re-use or has been re-used, the substitution of collateral at the end of the day and the haircuts applied.

Building on its experience with the EMIR and other EU-wide reporting regimes, ESMA has developed its reporting standards for SFTs in order to align reporting standards to the maximum extent possible. The standards were published in March 2019 in the Official Journal of the European Union[33] and the counterparties to SFTs are required to start reporting SFTs details 12 months after the date of their entering into force, i.e. 13 April 2020. It is worth noting that SFT reporting will use ISO 20022 standards for the entire reporting flow (i.e. from the reporting of transactions to TRs to the provision of reports to the reporting entities and to the relevant competent authorities).

The preparatory work for this new direct supervisory mandate gained further momentum in 2019. ESMA started engaging with pre-applicants, assessing the first applications for registration and continued to prepare the implementation of the supervisory framework in order to be ready for the start of the reporting requirement. The main steps currently undertaken are (i) the development of a data quality framework based on the EMIR one and (ii) the establishment of internal processes and procedures.

Securitisation Regulation

SECR creates a general framework for securitisations and a specific framework for simple, transparent and standardised securitisations (STS), with the aim of increasing transparency to the market. Under SECR, securitisation transactions will have to be reported to a repository that collects the data. In contrast to EMIR and SFTR, neither trading counterparties nor trades are captured under SECR, but only securitisations issued for which performance updates have to be provided regularly.

ESMA has been designated as the supervisor of securitisation repositories (SRs), in a similar manner to its supervision of TRs under EMIR and SFTR. As for SFTR, ESMA has built on its CRA and TR supervisory experience to identify and discuss with potential applicants to ensure that these are aware of the anticipated application process. ESMA has been preparing for new technologies that SRs may implement. On 29 November, the European Commission published the final version of the technical standards on application requirements, operational standards and disclosures, and submitted them for scrutiny of the European Parliament and the Council. Once these standards enter into force (i.e. 20 days following their publication in the Official Journal of the European Union), the first SRs may apply for registration.

ESMA is currently in the process of preparing its supervisory strategy to take up the supervision of the SRs. The main steps currently undertaken are: (i) the identification of the key regulatory requirements;

[33] OJ L 81/62, 22.3.2019, p.1

(ii) the building of knowledge regarding the supervisory mandate; (iii) the set-up of a data quality framework; and (iv) the establishment of internal processes and procedures.

ESAs Review

ESMA is conferred with additional direct supervisory tasks following the outcome of the review of the European System of Financial Supervision (the ESAs review).[34] From 1 January 2022, ESMA will be the direct supervisor of (i) European critical benchmarks (currently LIBOR, EURIBOR and EONIA) as well as of the third-country administrators subject to the recognition regime under the Benchmarks Regulation and (ii) data reporting service providers, namely Approved Reporting Mechanisms (ARM) [35], Approved Publication Arrangements (APA) [36], and Consolidated Tape Provider (CTP). [37]

ESMA will start the necessary preparatory work to set up the supervisory framework; (ii) its internal processes and procedures; and (iii) the technological tools needed for these new direct supervisory tasks.

[34] Regulation (EU) 2019/2175 of the European Parliament and of the Council of 18 December 2019 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), Regulation (EU) No 600/2014 on markets in financial instruments, Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, and Regulation (EU) 2015/847 on information accompanying transfers of funds.

[35] ARM means a person authorised to provide service of reporting details of transactions to competent authorities or to ESMA on behalf of investment firms.

[36] APA means a person authorised to provide services of publishing trade reports on behalf of investment firms pursuant to Articles 20 and 21 of MiFIR (post-disclosure by investment firms, including systematic internalisers, in respect (i) of shares, depositary receipts, ETFs, certificates and other similar financial instruments; and (ii) bonds, structured finance products, emission allowances and derivatives).

[37] CTP means a person authorised to provide the service of collecting trade reports for financial instruments from regulated markets, MTFs, OTFs and APAs and consolidating them into a continuous electronic lave data stream providing price and volume data per financial instrument.

Work Programme 2020

Work Programme 2020

ESMA uses a risk-based approach to establish its annual work programme for CRAs and TRs. This risk-based approach to supervision allows ESMA to ensure its resources are allocated where they can have the biggest impact and where the highest risks are identified. The risk assessment takes into account risks at a firm and industry level. It builds on the observed market trends and the current state of the CRA and TR industries in the EU. ESMA will also focus on its preparatory work in relation to the supervisory powers conferred to it under SFTR and SECR.

In defining its supervisory actions to address the identified risks, ESMA does not use a one-size-fits-all approach, but tailors its actions to the type of risk or challenge at stake, taking into account the urgency of the case, size, complexity and history of the supervised firm. In addition, ESMA differentiates its supervisory approach depending on the objective it wants to achieve. When ESMA identifies common issues across firms it adopts a thematic approach, which allows for peer comparisons. In other cases, where risks seem to impact a specific firm, ESMA opts for bespoke actions like “Dear CEO” letters, investigations, on-site inspections or engagement with various tiers of the management of the supervised firm.

For 2020, ESMA will need to prioritise supervisory activities. Brexit and the entry into force of SFTR and SECR will be key priorities for ESMA’s supervisory activities in 2020. Brexit will be a common priority across CRAs and TRs and ESMA will continue to engage with the supervised entities to ensure that there will be no disruption as a result of Brexit when it occurs. ESMA is currently reviewing applications for registration under SFTR and expects to receive applications for registration under SECR in Q2 2020. ESMA will also need to prepare for the entry into force of the amended Benchmarks Regulation and MiFIR (as described in the section on new supervisory mandates above). ESMA will also carry out general supervisory activities, including day-to-day monitoring, assessment of registration applications and performing on-site visits of SMCRAs (as described in the section on key supervisory activities of the CRA section).

Credit Rating Agencies

The key macro-economic trends that ESMA has taken into account for its 2020 work programme include:

Rating levels: a significant part of debt instruments is being rated BBB, the lowest category of investment grade ratings, which means that large scale downgrades could significantly affect financial markets.

Structured finance markets: an increase in the issuance in some structured finance asset classes including CLOs.

Economic growth: expected slowdown of economic growth over the course of 2020.

ESMA has also identified the following market trends:

Competitive landscape: the industry continues to be dominated by a small number of large and globally operating CRAs. At the same time, ESMA observes that some smaller market players are trying to increase their market share in specific asset classes.

Technology: new technologies are increasingly important for CRAs. Big data combined with AI can lead to a sophistication of models used and leads to an increased importance of data analytics. CRAs are also increasingly using cloud outsourcing.

Cybersecurity: as set out above, CRAs operate in a cybersecurity threat environment that is highly sophisticated and aggressive.

Sustainability: ESMA observes an increased importance of ESG factors.

Finally, through its risk assessment, ESMA has identified areas of focus for specific CRAs and/or the industry at large, which are described further in the sections below.

Risks in outstanding credit ratings

Key objective: pro-actively identify risks in outstanding credit ratings and take appropriate supervisory action where necessary

ESMA actively monitors trends in outstanding credit ratings on an ongoing basis through the information it receives from CRAs and other stakeholders. In 2020, ESMA intends to step-up its efforts in this respect to identify risks in outstanding credit ratings, specifically in the following areas:

BBB-rated bonds: As set out above, in recent years there has been a significant increase in BBB-rated bonds. This trend emphasizes the need for CRAs to ensure high quality of their underlying credit analysis so that their credit ratings accurately reflect the creditworthiness of the rated assets. In case of deteriorated macroeconomic prospects, CRAs may be forced to suddenly revise their creditworthiness assessment. In this scenario, the major investors in BBB debt, such as banks, insurers, pension funds and investment funds, may be exposed to a series of downgrades of BBB-rated companies to speculative grade, which, in turn, may have a disruptive impact on the financial markets.

ESMA will maintain its supervisory focus on this trend and continue to monitor the activities of CRAs to ensure that they produce high quality credit ratings that incorporate all available information in a timely manner and are free of conflicts of interest.

CLO instruments: Another important development is the increase in issuances of CLO instruments. In previous sections of this document, ESMA has described the developments in this market and the supervisory actions taken so far. In 2020, ESMA will publish a report covering three main issues: (i) the use of rigorous, systematic and continuous rating methodologies for CLO instruments; (ii) the validation of CLO credit ratings methodologies; and (iii) the ongoing monitoring of CLO credit ratings including the thorough analysis of all available information. Additional supervisory actions might be taken in this area.

In addition, ESMA will actively monitor the evolution in sovereign ratings.

Robustness of rating process

Key objective: ensure CRAs' rating processes are robust, well-structured and comply with all the requirements of the CRA Regulation

In 2020, ESMA will focus on ensuring that CRAs have a robust and well-structured rating process in place as this is key in order to produce high quality ratings. More specifically, ESMA will focus on the following topics:

Issue credit ratings investigation: Timely implementation of the remedial actions agreed with the CRAs that were subject to the issue credit ratings investigation. As set out in the key supervisory activities of the CRA section above, implementation of these controls will mitigate the risks around the processes these CRAs use for the assignment of issue credit ratings. These measures will be to the benefit of investors as they should lead to a reduction of errors in the assignment of such credit ratings.

Rating surveillance process: The work ESMA performed regarding the rating surveillance process of CRAs will lead to the publication of a Q&A to clarify ESMA's expectations in this respect. Following publication of this Q&A, ESMA will actively engage with CRAs to ensure proper implementation of the Q&A across the CRA industry.

New technologies: Over the past years, ESMA has observed that new technologies, for example in the area of big data, AI and Machine Learning, are impacting the rating process of CRAs and the role of rating analysts. ESMA intends to engage with the industry over the course of 2020 in order to better understand these developments and assess the impact of these changes.

Preliminary Ratings: At the end of 2019, ESMA launched a survey to a sample of CRAs to better understand market practices on preliminary ratings. In 2020, ESMA will continue this work with a view to providing an appropriate form of guidance that establishes ESMA's expectations around preliminary ratings. This should enhance and harmonise disclosure to both the market and ESMA, delivering improved clarity for investors as well as better enabling ESMA to identify supervisory concerns, such as rating shopping.

Development and review of methodologies

Key objective: monitor whether CRAs use methodologies that are robust, systematic, continuous and subject to validation, including back-testing and understand drivers behind changes in methodologies.

The CRA Regulation requires CRAs to use methodologies that are robust, systematic, continuous and subject to validation, including back-testing. Methodologies are critical to ensure high quality credit ratings. The development and review of methodologies are an area of focus for ESMA. Changes to methodologies are systematically reviewed by ESMA to understand the impact of a change and to ensure CRAs follow the proper processes and comply with the requirements of the CRA Regulation. In 2020, ESMA will put more emphasis on this work through the following activities:

- The thematic review that is currently ongoing regarding credit ratings on CLO instruments and their respective methodologies (as described in the key supervisory activities section above);
- Closely reviewing the reasons for changes to methodologies that are notified to ESMA and the processes followed by CRAs in this respect;
- Assessing whether CRAs are incorporating all driving factors relevant for determining the creditworthiness of a rated entity or financial instruments in their methodologies.

IT & Information Security

Key objectives: monitor effectiveness of IT and information security controls; ensure effectiveness of IT systems development processes; monitor outsourcing risk to cloud service providers.

CRAs are increasingly becoming dependent on the proper functioning of their IT systems. Together with the adoption of new technological models (such as cloud computing) and the highly sophisticated and aggressive cyberthreat environment, IT and information security remain an important area for ESMA's supervision of CRAs in 2020. ESMA intends to focus on the following topics:

Information security controls: ESMA focused on cybersecurity through its thematic review performed in 2018 and 2019. In this review, ESMA has identified a number of supervisory concerns, which included the control framework that CRAs have in place to identify and recover from cyber-attacks. ESMA will engage with the industry in this respect over the course of 2020.

IT systems development processes: Given the importance of the IT applications and systems CRAs use to meet their business objectives, as well as the weaknesses ESMA has identified in the system development process of many firms in this sector, this will be an area of focus for ESMA's activities during 2020. Specifically, ESMA will aim at identifying specific risks and issues in the CRAs' IT system development process, with a view to gain assurance about the timeliness and quality of the IT systems delivered.

Cloud outsourcing: In view of the findings of the ESMA cloud computing survey of 2018, as well as the ongoing concerns during its monitoring activities in 2019, ESMA considers that outsourcing to cloud service providers is a risk that CRAs are not yet managing appropriately. In the course of 2020, ESMA will continue to focus on this risk area to identify any specific concerns and engage with the firms appropriately.

Access and usability of credit ratings

Key objective: ensure credit ratings are accessible and usable for investors.

One of the areas for improvement that ESMA identified while conducting follow-up work on the 2018 fees report relates to the access and usability of credit ratings. As described in the common areas of supervision section above, ESMA engaged with the three largest CRAs to improve access and usability of credit ratings published on their websites. In 2020, ESMA will monitor the implementation of these changes and assess their impact on the users of credit ratings and, where necessary, will consider whether additional actions need to be taken to facilitate access and usability of credit ratings by investors.

Effectiveness of control environment

Key objectives: ensure organisational arrangements do not impair independence and effectiveness of control functions; ensure compliance performs adequate and effective monitoring activities in line with the CRA's risk management framework

Organisation of internal controls: In line with the supervisory concerns in this area and ESMA's guidelines on internal controls (currently under development)[38], ESMA will work to address its concerns identified with certain CRAs in the reporting and organisation of controls functions (i.e. compliance, risk, information security and review functions, and internal audit) which ESMA believes impair the independence of these functions.

Compliance risk management and monitoring: Compliance (both process and function) has a crucial role to play to ensure compliance with the CRA Regulation. ESMA considers that this goes beyond regulatory relations and/or some standalone monitoring against established policies and procedures at function level. In this respect, ESMA will target its supervisory engagement to ensure that firms enhance the way compliance risk management and monitoring activities are conducted by the compliance function (i.e. risk-based approach, end-to-end on-going and separate evaluations, or some combination of the two used), and to ascertain that adequate controls are in place that ensure compliance with the CRA Regulation. In addition, ESMA will consider this enhancement and/or development of compliance risk management approaches are properly aligned with firm's existing risk management framework.

Trade Repositories

Through its risk assessment, ESMA has identified areas of focus for specific TRs and/or the industry at large, which are described further in the sections below.

Data quality and access by authorities

Key objective: enhance data quality in support of usability of derivates and SFT data

Data quality remains a key area of concern for ESMA. In 2020, ESMA will continue its ongoing supervisory activities that are part of the EMIR DQAP, including its engagement with authorities via the data quality log and its monitoring activities through data re-validation, inter-TR reconciliation, and the data quality dashboard.

In the context of the DQAP, ESMA will focus on the following areas and supervisory activities: (i) quality of TRACE position calculation, reconciliation status and rejection statistics reports; (ii) accuracy and completeness of TRACE Trade State Report; (iii) derivatives data access filtering; and (iv) data ingestion process.

Quality of EMIR TRACE position calculation, reconciliation status and rejection statistics reports: In line with the DQAP for the year 2020, ESMA will proceed with assessing the completeness and accuracy of the TRACE position calculation, reconciliation status and rejection statistics reports that TRs produce and send to the respective authorities.

Accuracy and completeness of EMIR TRACE Trade State report: ESMA will assess the completeness and accuracy of the TRACE Trade State Report in terms of its derivation from the Trade Activity reports that TRs receive on a daily basis.

Derivatives data access filtering: Continuing the relevant project that started during 2019, ESMA will assess the completeness of EMIR data TRs provide to NCAs by simulating the access filtering process over the Trade State

[38] See the Consultation Paper on Guidelines on Internal Controls for CRAs; 5 December 2019; ESMA33-9-355.

and Trade Activity reports that received from TRs.

Derivatives data ingestion process: ESMA will focus on the data ingestion process of selected TRs and will assess whether submitted data from counterparties are correctly stored in the TR databases.

SFTR data quality framework: ESMA will continue developing the SFTR data quality framework. This framework will then be used for the assessment of the SFT data quality.

IT process and system

Key objective: enhance effectiveness of IT controls; ensure effectiveness of IT systems development processes

Software change management: ESMA will continue monitoring and assessing the timely implementation of the various fixes/bugs identified by TRs or EMIR data users.

Software testing process: ESMA will continue to monitor and assess the internal controls that TRs have put in place in the context of their Software Development Lifecycle and particularly on the process of testing adequately functional and non-functional requirement and changes.

Incident reporting: Incident reporting and analysis is a crucial process to identify the root cause of control failures and proceed with effective remediation actions. ESMA will review the respective process of the TRs, assess frequency and quality of reporting, and take appropriate remedial actions as necessary.

Information security and business continuity planning

Key objective: enhance effectiveness of information security function, ensure that effective and up to date business continuity plans are in place

Information security: TRs also operate in a cybersecurity threat environment that is highly sophisticated and aggressive; cybersecurity is thus a key consideration for ESMA's work this year as well. ESMA is taking a comprehensive approach in supervising cybersecurity aspects within the Information Security risk area. In this context, ESMA is planning to engage with key staff from the information security function of selected TRs to assess the information security related scope of work, security review findings and respective follow-ups, security operations, and adequate coverage of the TR specific processes, systems and infrastructure. Depending on the outcome of this review, ESMA may request appropriate remedial actions.

Business continuity: Based on its risk assessment, ESMA has identified the area of business continuity and disaster recovery as a priority for some TRs due to weaknesses in their business continuity and disaster recovery organisation, recovery plans update, and the adequacy of their testing programme. In this context, ESMA will review the plans, activities and effectiveness of the respective teams and request appropriate remedial actions.

SFTR registration follow up: Following the registration of TRs, ESMA will focus its supervision on the potential risks that have been identified during the registration process.

Third-Country CCPs & CSDs

Third-Country Central Counterparties

Recognition

According to Article 25 of EMIR, central counterparties established in third countries (TC-CCPs) can only provide clearing services to European clearing members if they are recognised by ESMA. In addition, under the Capital Requirements Regulation (CRR), EU credit institutions, investment firms and their third-country subsidiaries may only benefit from advantageous capital treatment with respect to cleared derivatives transactions, when the CCP they are facing is recognised by ESMA. This has led 50 TC-CCPs to apply for recognition to ESMA (as of 31 December 2019).[39]

One of the conditions to be fulfilled for a TC-CCP to be recognised is the adoption by the European Commission of an implementing act determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that third country comply with legally binding requirements which are equivalent to the EMIR requirements, the so-called "equivalence decision". Another condition that needs to be respected is for ESMA to conclude cooperation arrangements with the relevant third-country authorities.

During 2019, ESMA issued several communications with respect to Brexit confirming that ESMA considered that the conditions for recognition under Article 25 of EMIR were met by the three UK-based CCPs in case of a no-deal Brexit.[40] Therefore, it has adopted decisions to recognise them as TC-CCPs under EMIR. The recognition decisions would take effect on the date following the Brexit date, in a no-deal Brexit scenario.

The Brexit original deadline was extended several times. The last time was on 30 October 2019, when the Council decided to extend again the period relating to the UK withdrawal from the EU under Article 50(3) of the Treaty on European Union. ESMA, thus, informed its stakeholders that the reference date for Brexit in all of ESMA's previously published measures and actions, including public statements, issued regarding the possibility of a no-deal Brexit scenario, should be read as 31 January 2020.[41]

Given the nature of the current extension and the high level of uncertainty as to the final timing and conditions of Brexit, ESMA will issue further announcements and adjust and update its contingency measures (i.e. the conditional recognition decisions) for the UK-based CCPs as matters develop, and will inform the public accordingly.

On-going monitoring

Whilst ESMA does not have, as such, direct supervision powers over TC-CCPs, ESMA has to monitor TC-CCP activity as stated in the ESMA Regulation[42] and in the context of EMIR[43] to ensure EU financial stability. In addition, ESMA should assess whether the classes of OTC derivatives cleared by

[39] https://www.esma.europa.eu/sites/default/files/library/list_of_applicants_tc-ccps.pdf.

[40] https://www.esma.europa.eu/press-news/esma-news/managing-risks-no-deal-brexit-in-area-central-clearing
https://www.esma.europa.eu/press-news/esma-news/esma-ready-review-uk-ccps%E2%80%99-and-csds%E2%80%99-recognition-applications-no-deal-brexit
https://www.esma.europa.eu/press-news/esma-news/esma-agrees-no-deal-brexit-mous-bank-england-recognition-uk-ccps-and-uk-csd
https://www.esma.europa.eu/press-news/esma-news/esma-recognise-three-uk-ccps-in-event-no-deal-brexit
https://www.esma.europa.eu/sites/default/files/library/esma71-99-1269_esma_updates_its_recognition_of_uk_ccps_and_csd.pdf

[41] https://www.esma.europa.eu/press-news/esma-news/esma-update-brexit-preparations

[42] Recital 43 of Regulation (EU) No 1095/2010 sets out that: "*In order to safeguard financial stability it is necessary to identify, at an early stage, trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. [ESMA] should monitor and assess such developments in the area of its competence and, where necessary, inform the EP, the Council, the [EC], the other [ESAs] and the ESRB on a regular and, as necessary, on an ad hoc basis.*"

[43] See for example recital 19 of the EC implementing act for Japan which also states that "*The [EC], informed by ESMA, should continue monitoring the evolution of the Japanese legal and supervisory framework for CCPs and the fulfilment of the conditions [laid down in Article 25(6) of EMIR] on the basis of which [the] decision has been taken.*"

recognised TC-CCPs should be subject to the clearing obligation.

Therefore, following the recognition of a TC-CCP, ESMA has the obligation to regularly monitor the range of activities and services that the TC-CCP provides in the EU, to be able to identify potential situations in which the recognition of the CCP should be reviewed. In the context of the CFTC-regulated CCPs, ESMA also has to monitor the conditions set by the European Commission in the equivalence decision.

For example, instead of adopting one of the EMIR Anti-Procyclicality tools CFTC-regulated CCPs can choose to adopt equivalent measures, which one of them did. Therefore, ESMA receives quarterly updates on the performance of the relevant CFTC-regulated CCP regarding the stability and conservativeness of those measures to regularly check that equivalence is guaranteed.

In performing those monitoring tasks, ESMA has decided to focus on the risks that are more likely to materialise and negatively impact the EU financial stability or orderly markets or cause harm to investors.

To this end, for recognised TC-CCPs, ESMA has gathered information on interlinkages and exposures of EU entities with the TC-CCP. Leveraging on the CPMI public disclosure framework, ESMA has requested data covering six areas:

- The EU products, currencies and trading venues serviced by the TC-CCP;
- The EU clearing members' activity within the TC-CCP in securities and derivatives (exchange traded and OTC);
- The corresponding EU clearing members' exposures (default contribution, margin provision and power of assessment);
- Liquidity resources provided by EU entities to the TC-CCP;
- Interoperability arrangements between the TC-CCP and EU CCPs; and
- Qualitative information on important changes at the TC-CCP.

Under the relevant MoUs[44], ESMA has requested the assistance of the third-country authorities to obtain the above-mentioned information. The MoUs stipulate that requests for information should be made in a manner that is consistent with the goal of minimising administrative burdens. With this objective in mind, ESMA will keep on conducting such request for information on a yearly basis, while encouraging the third-country authorities to inform ESMA of any relevant change in the CCP activity as soon as they become aware of it.

Work Programme 2020

Further to the necessary steps of reviewing and checking the data received and issuing corresponding follow-up requests, ESMA has finalised its analysis on potential risks recognised TC-CCPs might bring to the EU and has identified the areas of monitoring focus for the following years.

On 13 March 2019, the European Parliament, the Council and the European Commission reached a political agreement on the review of the regulatory framework for the authorisation and supervision of CCPs established in Title III of Regulation 648/2012 (EMIR 2.2). EMIR 2.2 entered into force on 1 January 2020.[45]

This review of EMIR introduces a new category of TC-CCPs, the systemically important or likely to become systemically important CCPs (Tier 2 CCPs), which in order to be recognised under Article 25 of EMIR, have to comply, among other things, with the EMIR requirements set out in Article 16 and Titles IV and V of EMIR (see new Article 25(2b)(a) of EMIR). Those Tier 2 CCPs will be under ESMA's ongoing direct supervision whereas Tier 1 CCPs will be

[44] https://www.esma.europa.eu/regulation/post-trading/central-counterparties-ccps
[45] Regulation (EU) 2019/2099 of the European Parliament and of the Council of 23 October 2019 amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs.

subject to the currently applicable regime of recognition and on-going monitoring.

The European Commission is tasked with adopting a delegated act in accordance with Article 82 of EMIR to further specify the criteria set out in Article 25(2a) of EMIR within 12 months from the entry into force of EMIR (second subparagraph of Article 25(2a) of EMIR). The same applies with regards to a delegated act on comparable compliance minimum elements to be assessed and modalities and conditions to carry out the assessment (Article 25a(3) of EMIR) as well as one for fees associated to application and annual fees for recognised TC-CCPs (Article 25d of EMIR).

Once the delegated acts on tiering and comparable compliance will be in force, ESMA will be able to exercise its powers fully and execute the new recognition process (Article 89(3a) of EMIR) for the new TC-CCP applicants and also for the TC-CCPs which are already recognised and for which ESMA has 18 months to review the recognition decision (Article 89(3c) of EMIR).

In this context, in 2020 ESMA will focus on re-assessing the current TC-CCPs recognition decisions, including the UK-based CCPs ones as appropriate, and then perform the corresponding supervisory and monitoring actions depending on the tier where each TC-CCP stands with all the corresponding supervisory and enforcement measures described in Articles 25f to 25q.

In the context of initial recognitions, re-assessment of original recognition decisions under Article 89(3c) of EMIR or of extensions of range of activities and services, ESMA will assess whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

Furthermore, ESMA will also continue to co-operate with third-country authorities, through the current MoUs that will need to be updated based on the new version of Article 25(7) of EMIR, and analyse the data received, mainly for Tier 1 CCPs to ensure that TC-CCPs comply on an ongoing basis with the EMIR criteria and equivalence conditions and that the services provided to EU entities do not expose the latter to undue risks.

Regarding TC-CCPs, ESMA will also have to establish and manage a college to facilitate the sharing of information on TC-CCPs, within four months of the entry into force of the tiering delegated act.

In parallel, and in relation to the results of the data request of 2019 (i.e. under the old regime), ESMA, waiting for updated data under the new scheme, can still use them to monitor the indicators evaluating whether there are potential risks for the EU emerging from TC-CCP activity.

The monitoring of TC-CCPs for 2020 onwards will be similar to the current one for Tier 1 CCPs. A specific monitoring scheme will be created for the Tier 2 CCPs to reflect the enhanced supervisory framework and specifically ESMA's ongoing supervision of the compliance of recognised Tier 2 CCPs with the requirements referred to in Article 25(2b)(a) i.e. compliance with the requirements set out in Article 16 and Titles IV and V of EMIR, coordinating with the central banks of issue when required.

Third-Country Central Securities Depositories

Recognition

Under CSDR, ESMA recognises TC-CSDs that provide notary or central maintenance services in relation to financial instruments constituted under the law of a Member State or set up a branch in a Member State. A prerequisite for recognition is the adoption of an equivalence decision by the European Commission in respect of the jurisdiction of the TC-CSD. So far, there have been no equivalence decisions adopted by the European Commission, except for the one with respect to the UK on 19 December 2018 (as amended on 3 April 2019).

In 2019, following the publication of the equivalence decision by the European Commission with respect to the UK, ESMA signed the corresponding MoU with the Bank of England, the competent authority for the UK-based CSD.

On 4 April 2019, ESMA adopted a recognition decision with respect to the UK-based CSD, which would apply in a no-deal Brexit scenario.

On-going monitoring

Whilst ESMA does not have, as such, direct supervision powers over TC-CSDs, ESMA has to monitor TC-CSD activity as stated in the ESMA Regulation[46] and in the context of CSDR to ensure EU financial stability.

Therefore, following the recognition of a TC-CSD, ESMA has the obligation to regularly monitor the range of activities and services that the TC-CSD provides in the EU to be able to identify potential situations in which the recognition of the TC-CSD should be reviewed.

In 2020, ESMA may need to adopt a new recognition decision regarding the UK-based CSD provided that the European Commission issues a new equivalence decision on the UK's regulatory framework for CSDs. In this case, ESMA will assess whether the UK-based CSD complies with the CSDR recognition criteria and the equivalence conditions.

Additionally, if applicable, following the adoption by the European Commission of equivalence decisions in respect of other TC-CSDs' jurisdictions, ESMA may need to assess the recognition applications submitted by other TC-CSDs.

[46] Recital 43 of Regulation (EU) No 1095/2010 sets out that: "*In order to safeguard financial stability it is necessary to identify, at an early stage, trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. [ESMA] should monitor and assess such developments in the area of its competence and, where necessary, inform the EP, the Council, the [EC], the other [ESAs] and the ESRB on a regular and, as necessary, on an ad hoc basis.*"