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| 04 April 2017 |

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| Reply form for the Consultation Paper on  Update of the guidelines on the application of the endorsement regime under  Article 4(3) of the Credit Rating Agencies Regulation |
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| Date: 04 April 2017 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in Consultation Paper on update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (CRA), published on the ESMA website.

*Instructions*

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

* use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
* do not remove the tags of type <ESMA\_QUESTION\_CRA\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
* if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

* if they respond to the question stated;
* contain a clear rationale, including on any related costs and benefits; and
* describe any alternatives that ESMA should consider

**Naming protocol**

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA\_CRA\_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA\_ CRA \_XXXX\_REPLYFORM or

ESMA\_ CRA \_XXXX\_ANNEX1

***Deadline***

Responses must reach us by **03 July 2017.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings ‘Legal notice’ and ‘Data protection’.

# General information about respondent

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| --- | --- |
| Name of the company / organisation | Fitch Ratings |
| Activity | Other Financial service providers |
| Are you representing an association? |  |
| Country/Region | UK |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_CRA\_1>

Introductory Comments

Fitch welcomes the opportunity to provide its comments with respect to ESMA’s Consultation Paper relating to the “Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation” (the “**CP**”).

We begin by noting that ESMA is proposing a material change to the existing guidelines on the application of endorsement. Currently, the determination of the endorseability of ratings from any given third country is based solely on the legal regime for CRAs in that country: ESMA makes a determination that this legal regime is “as stringent as” the specified provisions in the EU CRA Regulation, and enters into a cooperation agreement with the relevant supervisor in this legal regime, thereby allowing an EU-registered CRA to endorse ratings from that country. Now, ESMA is proposing to switch to an approach whereby ESMA makes a determination that the third-country legal regime meets only a “minimum standards” test[[1]](#footnote-2). Given that, ESMA adds an additional requirement: the EU-registered CRA can only endorse ratings from that country if the endorsing CRA determines that (i) the policies and procedures applicable to the third-country CRA are “carried out to ensure that they meet the requirements in Article 4(3)(b) of the [EU] CRA Regulation” and (ii) the endorsing CRA checks that the ratings to be endorsed were produced in accordance with those policies and procedures.

It would appear that the third-country CRA is now expected to “top up” its policies and procedures to make them consistent with the EU CRA Regulation, regardless of what is actually required under the laws and regulations applicable to CRAs in that country. However, this is the complete opposite of the settled interpretation of the law provided by the Commission[[2]](#footnote-3), and later applied by CESR and, indeed, ESMA up until today. For example, at paragraph 22 of ESMA’s existing guidelines, ESMA states that “the requirements ‘as stringent as the requirements set out in Articles 6 to 12’ of the [EU CRA] Regulation must be established by law or regulation, and not on a self-imposed basis. In fact, it seems inconsistent to require a third country to have a regulatory system which provides for authorization/registration and supervision of the CRAs, when the requirements ‘as stringent as’ could be met on a self-imposed basis”. In the same document, at paragraph 24, ESMA explains as follows: “The [EU CRA] Regulation does not envisage admissibility of a dual system of compliance with its requirements whereby local legal/regulatory duties in a third country would be ‘topped up’ by policies and procedures voluntarily followed by the third country CRA or the EU-registered, endorsing CRA. Therefore, the requirements as stringent as those set out in Articles 6 to 12 may only be established in law or regulation of that third-country in order to satisfy the condition laid down in Article 4(3)(b)”.

Fitch does not understand the legal basis on which ESMA can change the settled interpretation of the EU CRA Regulation. Moreover, there is no reference at all in Article 4 to a “minimum standards test”.

ESMA provides a practical (not a legal) explanation for the change. ESMA refers to three apparent “unintended consequences” of the current approach. The first such consequence is that it was difficult for the endorsing CRA to demonstrate and verify fulfillment of the “as stringent as” requirement because expertise with respect to the third country laws/regulations would sit with the third-country CRA, not the endorsing CRA. However, in Fitch’s view, ESMA’s conclusion is incorrect: under Article 4, the third-country CRA must be part of the group of companies to which the endorsing CRA belongs, therefore the knowledge of what is required by the third country CRA laws/regulations – and thus what is reflected in the third-country CRA’s policies and procedures – can be and is easily shared within the CRA group.

The second unintended consequence given by ESMA is that the current approach has limited ESMA’s ability to monitor and assess compliance of the third-country CRA. However, ESMA has ample powers under the EU CRA Regulation to request and receive information from the endorsing CRA (see Article 4(3)(d)) as well as the third-country supervisor via the relevant cooperation agreement (between such supervisor and ESMA). Indeed, given that ESMA is not supervising the third-country CRA, but simply monitoring and assessing the actions of the third-country CRA (see Article 4(3)(c)), ESMA does not require extensive information. Moreover, Fitch notes that part of ESMA’s assessment of the third-country regime involves a determination of the effectiveness of supervision and enforcement in the third country.

The third stated consequence, which ESMA claims “was not foreseen by the legislator”, is that the “requirements imposed on endorsed ratings have in practice been nearly indistinguishable from those imposed on credit ratings entering the EU market through the equivalence regime”. However, rather than this being an “unforeseen consequence”, this approach was the deliberate choice of ESMA’s predecessor, CESR – presumably with the full knowledge and consent of the Commission. In CESR/10-347, dated 4 June 2010 (CESR’s Guidance on Registration Process, Functioning of Colleges, Mediation Protocol, Information set out in Annex II, information set for the application for Certification and for the assessment of CRAs systemic importance), Section IV(4)(A) raises the question: “Should endorsed ratings and ratings issued by certified CRAs be subject to different requirements?” Based on Recitals 13 and 14 of the EU CRA Regulation, CESR responds to this question as follows: “Therefore, CESR considers that there would be no objective reasons to set different requirements for the third country CRAs depending on the mechanism used. The requirements according to which the ratings are produced should achieve the same objectives irrespective of the route the foreign CRA has to follow. This would ensure a level playing field for all rating agencies.”

Fitch notes, with respect to the last point, that ESMA attempts, in the CP at paragraphs 147-148, on the basis of what ESMA calls a “slight difference in wording”, to justify a different approach to endorsement and certification. ESMA states that it may “accept a lower level of effectiveness and enforcement powers”, with respect to the third country supervisor, when assessing that third country’s supervision and enforcement. It is unclear to Fitch why ESMA is taking this approach. Also, by the very fact of deciding that there is a difference – when there should be none – ESMA opens the door for requiring more from the endorsing CRA (i.e., the “top-up” regime described above).

Fitch therefore believes that there is no legal, practical or textual basis for ESMA reversing the past seven years’ legal interpretation and practice with respect to endorsement, and strongly urges ESMA to reconsider its proposed new approach.

Notwithstanding Fitch’s overall objection to this proposed approach, we provide below our responses to the specific questions asked about the details of the proposal.

<ESMA\_COMMENT\_CRA\_1>

1. Please indicate what you believe will be the impact of ESMA’s change in approach, if any, on the groups of CRAs currently benefiting from the endorsement regime? Please explain your reasoning.

<ESMA\_QUESTION\_CRA\_1>

If CRAs will be able to assess whether a third-country CRA has “as stringent as” policies and procedures on the basis of a holistic, objectives-based analysis, the impact on Fitch should be manageable. This type of analysis means that the third-country CRA’s policies and procedures do not have to address all the relevant sections listed in Article 4(3)(b), provided those policies and procedures achieve the same objectives that drive these sections. This approach is consistent with Recital 13 of the EU CRA Regulation (“When endorsing a credit rating issued in a third country, credit rating agencies should determine and monitor, on an ongoing basis, whether credit rating activities resulting in the issuing of such a credit rating comply with requirements for the issuing of credit ratings which are as stringent as those provided for in this Regulation, achieving the same objective and effects in practice.”) and Recital 48 of CRA 3 (“It is important to recall in this respect that a third-country regulatory regime does not have to have identical rules as those provided for in this Regulation. As already provided for in Regulation (EC) No 1060/2009, in order to be considered equivalent to or as stringent as the Union regulatory regime, it should be sufficient that the third-country regulatory regime achieve the same objectives and effects in practice.”).

This appears to be the approach proposed in the CP, given that both paragraph 30 of the main document, and paragraph 12 of Annex II, refer to a second option – specifically, that the third-country CRA “directly fulfills” the relevant provisions of the EU CRA Regulation.

If, however, this new approach means that the policies and procedures applicable to the third-country CRA must be exactly the same as those used by the endorsing CRA, the impact on Fitch will be material. As ESMA is aware, no third countries have implemented the changes introduced by CRA 3. Consequently, Fitch does not apply these changes outside the EU, and therefore this approach would involve a very significant change to the practices of Fitch’s third-country CRAs, as well as material costs.

In addition, one clear advantage of the current approach is that it is completely transparent: ESMA’s assessments of third countries are published, and all endorsing CRAs understand the basis for endorsement. The new approach is dependent on how each group of international CRAs makes its assessments of “as stringent as”. Fitch would therefore ask ESMA to consider how the new approach can be made more transparent, thereby ensuring that a level playing field is maintained for all endorsing CRAs. Furthermore, Fitch would appreciate clarification that – consistent with ESMA’s assessment of the minimum standards met by a third country’s CRA laws/regulations (see paragraph 5 of Annex III) – endorsing CRAs can also disregard the requirements of Article 8(d), as well as the provisions relating to sovereign ratings, when conducting their own assessments.

<ESMA\_QUESTION\_CRA\_1>

1. Please indicate whether you consider the measures which the endorsing CRA should have in place to monitor the conduct of the third-country CRA will adequately ensure the quality and independence of endorsed credit ratings?

<ESMA\_QUESTION\_CRA\_2>

Fitch seeks clarification on the following points: First, in paragraph 6 of Annex III, ESMA states that it “has not changed the criteria for assessing any of the requirements pre-dating CRA 3”. Given that this pre-CRA 3 assessment was done on the basis of a full determination of the “as stringent as” requirement, rather than a minimum standards test, does that mean that CRAs need only assess compliance by the third-country CRAs with the relevant provisions of CRA 3, as well as any future changes to the EU CRA Regulation? Fitch also appreciates that any changes to third-country CRA law/regulations would need to be assessed to determine whether the amended law/regulations still are “as stringent as” those in the EU.

Second, international CRA groups – who are, and will continue to be, the CRAs utilizing endorsement – have global Compliance teams and other global internal control teams. Fitch therefore assumes that its EU Compliance and/or other internal control teams can rely on the work done by their non-EU colleagues in assessing compliance by the third-country CRAs in the group with the applicable policies and procedures. Also, given that each of these global teams works closely as one unit, Fitch would like clarification on the ability of the entire team, wherever located, to assist the EU members of their team with fulfilling any of the tasks related to endorsement that ESMA expects to be undertaken by Compliance or one of the other internal control teams. Without this ability to work as a group, the additional costs imposed by this approach could be burdensome.

Finally, there are certain requirements under the EU CRA Regulation that ESMA has identified, in Figure 1 of the CP, as being “ongoing obligations of [the] endorsing CRA”. Some of these ongoing obligations, however, do not seem appropriate for the CRA. Specifically, the following requirements either appear to sit with ESMA, rather than the endorsing CRA, or should be deleted entirely, in each case for the reasons given below:

* 4(3)(b) ESMA check: “The legal and supervisory framework of third country meets a minimum standard.” Since ESMA will be making the determination of whether the third country meets the minimum standard, it therefore seems logical that ESMA undertakes any necessary ongoing monitoring with respect to its own determination.
* 4(3)(f) ESMA check: “There is a supervisor in the third country which authorizes or registers third-country CRAs and subjects them to supervision.” First of all, as there is a requirement for ESMA to enter into a cooperation agreement with the third-country supervisor, ESMA will not need any updates from the endorsing CRA. Secondly, this check is already included within the second check identified by ESMA under 4(3)(f) – i.e., that “the third-country CRA is authorized or registered, and is subject to supervision, in the third country where it is established”. Finally, we note that, in paragraph 21 of the CP, ESMA states that this subparagraph 4(3)(f) actually does not create ongoing obligations on the endorsing CRA.
* 4(3)(g): “The regulatory regime in the third country prevents interference by the competent authorities and other public authorities of that third country with the content of credit ratings and methodologies.” This ESMA check is explicitly excluded under Article 4(6) if, under Article 5, the Commission has made a determination of equivalence for a third country, and entered into a cooperation agreement with the relevant supervisor. And, similar to Article 4(3)(f), ESMA recognizes, in paragraph 21 of the CP, that there are no ongoing obligations on the endorsing CRA under this subparagraph (g).

<ESMA\_QUESTION\_CRA\_2>

1. Do you agree with ESMA’s understanding of points (c) and (d) of Article 4(3) of the CRA Regulation?

<ESMA\_QUESTION\_CRA\_3>

Fitch agrees with ESMA’s understanding, but also notes that, given that Article 4(3)(c) correctly specifies that ESMA is merely “assessing and monitoring” the activities of the third-country CRA, rather than supervising those activities, Fitch would expect ESMA’s information requirements with respect to third-country CRAs to be more limited, as already mentioned above.

<ESMA\_QUESTION\_CRA\_3>

1. In your view, are there other reasons which could be considered “objective” within the meaning of Article 4(3)(e)? If so please indicate which providing reasons.

<ESMA\_QUESTION\_CRA\_4>

First, Fitch notes that ESMA has added the requirement that the objective reason for the location of each rating be “documented”. That requirement is not specified in the EU CRA Regulation; the only relevant provision in Annex I, Section B, paragraph 7 (with respect to document retention) refers to “records of the procedures and measures implemented by the credit rating agency to comply with this Regulation”. It will be hugely burdensome to document an objective reason for each individual rating.

With respect to what reasons could be “objective” reasons, Fitch agrees that one objective reason for a rating to be elaborated in a particular country could be that the issuer to be rated is established, or the security to be rated is issued, in that country. However, Fitch also believes that there are many more objective reasons that could influence the location of a rating. Moreover, in any given situation, one of those reasons could be more compelling than another. For example, the rating of a subsidiary established in country A could be based on the rating of that subsidiary’s parent, established in country B. In such a case, Fitch would posit that there was an objective reason for the rating of the subsidiary to be elaborated in country B. In a related example, a bank may be located in country A, but its holding company is located in country B. Given that the rating of the holding company would be driven by the rating of the bank, the location for the rating of the holding company could, objectively, be country A.

Additionally, there are many countries in the world in which there are no CRAs – one example, in the EU, would be Luxembourg. One potential (unintended) conclusion that could be drawn from ESMA’s reliance on the location of the issuer/security is that, for a CRA to rate issuers/securities located in a particular country, the CRA must have an establishment in that country. We assume that was not ESMA’s intention. Indeed, CRAs may be located in particular countries for a variety of factors: ability to hire analysts with sufficient expertise, proximity to relevant markets, ease of establishment, robust governance framework, etc. All of these constitute objective reasons for the location of a CRA, which in turn drives the location of lead analysts, thereby determining the location of a rating. And the choice of a lead analyst can be driven by a host of different reasons – for example, the need to transfer responsibility for a rating when a lead analyst leaves a CRA. Moreover, the EU CRA Regulation does not require that ratings of EU issuers/securities be elaborated solely in the EU. Article 5, which deals with equivalence and certification, specifies that this regime applies to “credit ratings that are related to entities established or financial instruments issued in third countries”. There is no geographical restriction set out in Article 4. This is confirmed by ESMA’s guidance to non-EU CRAs on its own website: endorsement is described as applying to “Credit ratings on EU and non-EU issuers or instruments”.

Fitch believes that it would be difficult, if not impossible, to have an exhaustive list of what constitutes objective reasons for the location of a rating[[3]](#footnote-4). We therefore urge ESMA not to have a rigid definition of “objectivity”, and to recognize that one reason can objectively trump another. We would also ask that, at the time the new guidance comes into force, it be applied on a going forward basis only. Finally, we ask ESMA to consider how it can ensure a level playing field for all CRAs with respect to this topic.

<ESMA\_QUESTION\_CRA\_4>

1. Do you agree that the endorsing CRA should comply with the general requirements as listed in this section?

<ESMA\_QUESTION\_CRA\_5>

Fitch has no comments, other than to refer to its response to Question 2 seeking clarification about the ability of each EU internal control team to rely on resources within the relevant global internal control team, and also to state that each CRA should be able to choose which team(s) fulfill these requirements, as opposed to ESMA specifically assigning responsibility for monitoring and verification solely to the Compliance team.

<ESMA\_QUESTION\_CRA\_5>

1. Fitch notes that there appears to be no difference between the previous assessment of “as stringent as” and the assessment completed under the “minimum standards test”. [↑](#footnote-ref-2)
2. Letter, dated 8 October 2009, from Emil Paulis, Director of Financial Services Policy and Financial Markets (within the Internal Markets and Services DG of the European Commission), to Karl-Burkhard Caspari, at CESR, in which Mr Paulis states: “. . .the regulatory regime in the third country has to establish (enforceable) requirements which are as stringent as those provided for in the Regulation”. [↑](#footnote-ref-3)
3. We note that CESR, in its FAQs dated 4 June 2010 (Ref: CESR/10-521), states the following: “Non-exhaustive examples of potential objective reasons for elaborating ratings in a third country could be: 1) the CRA has only recently opened an EU office and the staff that have the experience rating the EU entities that they cover are based outside the EU – immediately transferring the rating of these entities to the new EU office may lead to a decline in the quality of the rating. 2) corporate action (for example a takeover/merger) means the rating activity does not reflect new corporate structures”. [↑](#footnote-ref-4)