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Moody's Ratings' response to ESMA's Consultation on Proposed Revisions to Commission Delegated Regulation (EU) 447/2012 and Annex I of the CRA Regulation

Moody's Ratings welcomes the opportunity to comment on ESMA's proposed revisions to Commission Delegated Regulation (EU) 447/2012 (the **Delegated Act**) and to Annex I of the CRA Regulation (**Annex I**).

We support ESMA's and the Commission's intention of ensuring that ESG considerations are systematically captured in credit ratings, where materially relevant to credit, and to provide for a good level of transparency around these considerations.

For our own operations, we have gradually expanded our toolset to provide extensive transparency on our approach to incorporating material ESG considerations into credit analysis amid heightened interest from market participants and regulators alike. As a matter of course, we have fully implemented the 2019 Guidelines whereby we indicate in rating announcements if ESG considerations are a driver of a rating action and provide accompanying disclosure in the announcement. In addition, we have chosen to implement a range of complementary measures which we set out in Annex I to this submission.

However, we have identified certain aspects of the proposals that we believe would benefit from further consideration and clarification. As drafted, there is a risk of potential misunderstandings and conflicts with existing duties and requirements. Specifically, we would highlight the following three concerns:

1. A potential requirement to classify all rating drivers as either E, S, G, or otherwise, may interfere with our primary analytical focus on credit quality and conflict with the CRA Regulation.

2. The new disclosure requirements in Annex I could be understood as a departure from the 2019 Guidelines on Disclosure Requirements Applicable to Credit Ratings[1].

3. The proposed amendments to the Delegated Act could be understood as introducing additional substantive requirements in respect of all methodologies, which we understand is not ESMA's intention.

We elaborate on each of these points below.

[1] ESMA 33-9-320: Final Report – Guidelines on Disclosure Requirements Applicable to Credit Ratings, 18 July 2019.

1. **A potential requirement to classify all rating drivers as either E, S, G, or otherwise, may interfere with our primary analytical focus on credit quality and conflict with the CRA Regulation.**

   ESMA's proposed amendments to Article 4(2) include a requirement that credit rating methodologies shall list each qualitative and quantitative factor and identify in each case whether a factor is considered as an E, S, or G factor.

   As drafted, such a requirement appears to imply that the impact of E, S, or G can always be isolated and extracted from other credit drivers, which is contrary to our experience and analysis.

   We have evolved our methodologies over many years to identify the rating drivers that are most relevant to credit quality. We maintain primary methodologies that are sector-specific, complemented with a variety of supplementary methodologies that are applicable across sectors. They are to be read in conjunction with our Ratings Symbols & Definitions publication.

   We have chosen to address ESG considerations in a cross-sector methodology as we have found that ESG considerations tend to cut across primary rating drivers, rather than being separate, and are therefore best understood as an overlay to our sector-specific methodologies. In practice, we incorporate ESG considerations in a variety of ways: either directly or indirectly in scorecard factors, models or metrics, or more generically as other considerations outside the scorecard or model.

   In some instances, we might be able to delineate aspects of our analysis as an E,S, G or otherwise factor, but it would be difficult to do so for others.

   For example, our primary methodology for auto manufacturers includes rating considerations such as Business Profile, Profitability and Leverage. We do not believe that a categorisation of these rating drivers as either E, S, or G, at a sector level, would provide much insight to the users of our ratings.

   Instead, our ESG cross-sector methodology provides our definition of E, S and G considerations and sets out how we incorporate these matters in the rating process. Our Credit Impact Scores (output of the rating process) and Issuer Profile Scores (input to the rating process) provide transparency on how E, S and G considerations manifest for a specific issuer, and their degree of materiality.

   We agree with an expectation that CRAs demonstrate how E, S and G considerations affect an entity's credit profile and that such considerations link back to the CRA's methodologies. However, we believe that a level of flexibility is crucial to allow each CRA to consider how best to achieve these objectives, while not undermining the quality of its ratings. By seeking to impose a rigid categorisation, the proposed requirements risks interfering with a CRA's wider methodological approach and analytical focus.

   Indeed, we believe that the proposed requirements risk a conflict with our duties under the CRA Regulation to ensure that our credit ratings are independent, objective and of adequate quality, and appear contrary to the prohibition under Article 23(1) of the CRA Regulation against interference by competent authorities with the content of credit ratings and methodologies.

2. **The new disclosure requirements in Annex I could be understood as a departure from the 2019 Guidelines on Disclosure Requirements Applicable to Credit Ratings.**

   The 2019 Guidelines require disclosure in respect of ESG considerations that contribute to the rating action, as communicated in the press release. This is as opposed to disclosure of ESG considerations that underlie the credit rating at an absolute level. This was a well-discussed distinction.[2]

ESMA's proposed amendments to Annex I now appear to require disclosure of ESG considerations in respect of the absolute level of the rating. We understand that it was not ESMA's intention to change the nature of the requirement as set out in the 2019 Guidelines, but rather to complement it with additional specifications in respect of first-time ratings. We encourage ESMA to provide clarification and amendments to its proposed requirements.

3. **The proposed amendments to the Delegated Act could be understood as introducing additional substantive requirements in respect of all methodologies, which we understand is not ESMA's intention.**

ESMA's proposes amendments to the Delegated Act pertaining to the following areas:

i. A definition of a "credit rating methodology",
ii. The reference to "rating outlooks", as well as credit ratings throughout the Delegated Regulation,
iii. Extensive new wording in respect of the content of methodologies,
iv. A requirement that methodologies need to be "sufficiently detailed", and
v. A requirement that validation includes an assessment of the appropriateness of input data.

We understand that the amendments are intended to address inconsistencies in the regulatory framework. Given the potential for misinterpretation we would ask for confirmation that these amendments should not be interpreted as imposing substantially new or enhanced requirements.

We have proposed amendments to ESMA's draft requirements in Annex II of this submission, together with our responses to ESMA's detailed questions.

Yours sincerely,

/S/ Nick Miller

Nick Miller

Managing Director – Global Regulatory Affairs

[2] See the discussion under Question 4 in ESMA's Feedback Statement in the Final Report – Guidelines on Disclosure Requirements Applicable to Credit Ratings, starting from page 16.

Annex I – Moody's Ratings actions to provide transparency on E, S and G considerations in credit ratings

We have gradually expanded our toolset to provide extensive transparency on our approach to incorporating material ESG considerations into credit analysis amid heightened interest from market participants and regulators alike.

As a matter of course, we have fully implemented the 2019 Guidelines whereby we indicate in rating announcements if ESG considerations are a driver of a rating action and provide accompanying disclosure in the announcement.

In addition, we have chosen to implement the following complementary measures:

- Elaboration of our [ESG General Principles Methodology](), which is a cross-sector methodology that provides a consistent approach to our consideration of E, S and G in credit ratings. It includes appendices that provide additional guidance for specific sectors, including sovereigns, enterprises and financial institutions among others. It was first published in January 2019 and we have continued to develop and refine it since then.

- Roll-out of credit impact scores (CIS) and issuer profile scores (IPS) across our fundamental ratings for sovereigns, regional and local governments, enterprises and financial institutions; thereby covering around 11,900 entities. IPS are opinions of an issuer's or transaction's exposure to E, S and G considerations. They incorporate meaningful mitigating or strengthening actions related to those specific exposures. CIS communicate the impact of ESG considerations on the rating of an issuer or transaction, in the context of the issuer's or transaction's other credit drivers that are material to a given rating. The IPS and CIS are now inextricably linked to the assignment of the public rating.

- Introduction of an ESG training programme for our analytical staff, which includes an ESG certification module for managers, analysts and rating associates.

- Set up of a specialised team with cross-functional expertise on ESG and a dedicated ESG global credit officer to provide oversight to our approach to integrating ESG into credit analysis, including our ESG scores.

Through the above we believe that we provide high levels of ESG transparency, clearly demonstrating how E, S and G considerations affect an entity's credit profile and how such considerations link back to our methodologies. This has been publicly recognised. In 2023, we were named "most transparent credit rating agency" by Environmental Finance[3].

[3] https://www.environmental-finance.com/content/awards/sustainable-investment-awards-2023/winners/most-transparent-credit-rating-agency-moodys-investors-service.html. Results for 2024 have not yet been announced.

Annex II – Responses to specific questions & amendment suggestions

Q1: Do you agree with the above proposed changes in Article 1? If not please explain.

We would suggest deleting the reference to driving factors. This is an ambiguous term that is not part of the CRA Regulation, and it is not apparent how it is different from the much clearer term "criteria".

ESMA Proposed Amendment	Moody's Ratings Suggestion
<u>Article 1</u> This Regulation lays down the rules to be used in the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009. ***For the purpose of this regulation, a credit rating methodology is the framework that contributes to the determination of a credit rating and rating outlooks. It includes criteria, models, driving factors and key rating assumptions relevant to the creditworthiness assessment.***	<u>Article 1</u> This Regulation lays down the rules to be used in the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009. ***For the purpose of this regulation, a credit rating methodology is the framework that contributes to the determination of a credit rating and rating outlooks. It includes criteria, models~~, driving factors~~ and key rating assumptions relevant to the creditworthiness assessment.***

Q2: Do you agree with the changes proposed in Article 3? If not, please explain.

In line with our comment under Question 1 above, we suggest deleting the reference to driving factors.

ESMA Proposed Amendment	Moody's Ratings Suggestion
<u>Article 3 paragraph 2</u> When examining the compliance of credit rating agencies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009, ESMA shall use all information relevant to assess the process of developing, approving, using, validating and reviewing credit rating methodologies. ***In carrying out the compliance assessment, ESMA will consider that a credit rating methodology is the framework which contributes to the determination of a credit rating and rating outlooks. It includes criteria, models, driving factors and key rating assumptions relevant to the creditworthiness assessment.***	<u>Article 3 paragraph 2</u> When examining the compliance of credit rating agencies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009, ESMA shall use all information relevant to assess the process of developing, approving, using, validating and reviewing credit rating methodologies. ***In carrying out the compliance assessment, ESMA will consider that a credit rating methodology is the framework which contributes to the determination of a credit rating and rating outlooks. It includes criteria, models~~, driving factors~~ and key rating assumptions relevant to the creditworthiness assessment.***

Q3: Do you agree with the changes proposed in Article 4(1)(d)? If not, please explain.

We suggest maintaining the current wording. The proposed language appears to imply that assumptions and criteria are always in place. That is true for criteria, but not necessarily for models or sector-specific key rating assumptions.

ESMA Proposed Amendment	Moody's Ratings Suggestion
Article 4(1) (d) incorporate reliable, relevant and quality related analytical models, key credit rating assumptions and criteria ~~***where these are in place***~~.	Article 4(1) (d) incorporate reliable, relevant and quality related analytical models, key credit rating assumptions and criteria ***where these are in place.***

Q4 Do you agree with the proposed changes in Article 4(2) to the Delegated Regulation? If not, please explain.

We have several concerns with the proposed amendments, as follows:

i. The requirement that credit rating methodologies shall list each qualitative and quantitative factor and identify in each case whether a factor is considered as an E, S, or G factor appears to imply that the impact of E, S, or G can always be isolated and extracted from other credit drivers, which is contrary to our experience and analysis. Please see our comments under point 1 in the Cover Letter for further explanation.

ii. We propose references to materiality, so as to clarify that methodologies do not need to list all potentially relevant factors, which would be impractical, but only those that are material to credit.

iii. We propose language to clarify that models need not be provided in full, as this could require CRAs to disclose proprietary information. We also suggest deleting references to data sources as these are relevant to the application of the methodology, rather than being an intrinsic part of methodologies.

ESMA Proposed Amendment	Moody's Ratings Suggestion
Article 4 (2) 2. A credit rating agency shall use and apply credit rating methodologies which: ***(a) list each qualitative factor including the scope of qualitative judgement for that factor and identify, where applicable, whether a factor is considered as an E factor, S factor, G factor;***	2. A credit rating agency shall use and apply credit rating methodologies which: ***(a) list each material qualitative factor ~~including the scope of qualitative judgement for that factor and identify, where applicable, whether a factor is considered as an E factor, S factor, G factor~~;***

(b) list each quantitative factor and identify, where applicable, whether a factor is considered as an E factor, S factor, G factor;	***(b) list each <u>material</u> quantitative factor ~~and identify, where applicable, whether a factor is considered as an E factor, S factor, G factor~~;***
(c) include the rationale according to which qualitative and quantitative factors are considered within the creditworthiness assessment.	***(c) include the rationale according to which qualitative and quantitative factors are considered within the creditworthiness assessment.***
(d) include the key variables, data sources, key assumptions, modelling, and quantitative techniques applicable to the quantitative and qualitative factors used.	***(d) include the key variables, ~~data sources,~~ key assumptions, modelling techniques applied, and quantitative techniques applicable to the quantitative and qualitative factors used.***
(e) include the process according to which a qualitative or quantitative factor has been identified as an E factor, S factor or G factor.	***(e) ~~include the process according to which a qualitative or quantitative factor has been identified as an E factor, S factor or G factor.~~***

Q5: Do you agree with the above proposed changes in Article 4(3) to the Delegated Regulation? If not, please explain why not.

We understand that ESMA considers the references to "rating outlooks" to be a clarifications of existing practice and a clean-up of minor discrepancies in the legislative texts, rather than a desire to introduce additional requirements in respect of rating outlooks. We have no reservations on principle but would encourage ESMA to provide confirmation.

Q6: Do you agree with the above proposed changes in Article 5 to the Delegated Regulation on Methodologies? If not, please explain why not.

We understand that the proposed amendments are intended to address inconsistencies in the application of the existing rules. We would ask for clarification that these amendments should not be interpreted as imposing substantially new or enhanced requirements.

Q7: Do you agree with the proposed changes in Article 6 to the Delegated Regulation on Methodologies? If not, please explain.

Our overarching methodological approach applies to outlooks, as well as credit ratings. However, outlooks are different in nature. For example, we test the performance of our ratings at a notch level, regardless of their outlook status.

We understand that ESMA did not mean to imply such a requirement and would welcome clarification to this effect.

Q8: Do you agree with the proposed changes in Article 7 to the Delegated Regulation? If not, please explain.

The proposed changes to Article 7(2)(a) could be read as requiring tests of the performance of credit rating outlooks. We understand from ESMA that such a requirement was not intended. For clarity, we would suggest omitting the reference to rating outlooks in this Article.

In Article 7(3), we suggest an amendment intended to clarify that the assessment of the input data refers to the data used to develop, review and approve the methodology as part of the validation process, as opposed to data used in the application of the methodology in the ongoing credit rating process.

ESMA Proposed Amendment	Moody's Ratings Suggestion
Article 7(2)(a) A credit rating agency shall use credit rating methodologies that describe the following: (a) the historical robustness and predictive power of credit ratings ***and rating outlooks*** issued using the relevant methodology over appropriate time horizons and across different asset classes; Article 7(3) The validation of a credit rating methodology shall be designed to: [...] ***(ca) assess the input data used by a credit rating methodology for completeness, accuracy and appropriateness*** Article 7(5)(a) In the process of reviewing credit rating methodologies, a credit rating agency shall include: (a) regular credit rating***, rating outlook*** and performance reviews on rated entities and financial instruments	Article 7(2)(a) A credit rating agency shall use credit rating methodologies that describe the following: (a) the historical robustness and predictive power of credit ratings ~~***and rating outlooks***~~ issued using the relevant methodology over appropriate time horizons and across different asset classes; Article 7(3) The validation of a credit rating methodology shall be designed to: [...] ***(ca) assess the input data used for validation purposes ~~by a credit rating methodology~~ for completeness, accuracy and appropriateness*** Article 7(5)(a) In the process of reviewing credit rating methodologies, a credit rating agency shall include: (a) regular credit rating***, rating outlook*** and performance reviews on rated entities and financial instruments

Q9: Do you agree with the proposed addition of new paragraph 5a in Annex I.D.I to the Delegated Regulation? If not, please explain.

The 2019 Guidelines require disclosure in respect of ESG considerations that contribute to the rating action, as communicated in the press release. This is as opposed to disclosure of ESG considerations that underlie the credit rating at an absolute level. This was a well-discussed distinction.[4]

ESMA's proposed amendments appear to require disclosure of ESG considerations in respect of the absolute level of the rating, which would be a departure from the 2019 Guidelines. We understand that its intention was rather to complement the 2019 Guidelines with additional specifications in respect of first-time ratings and suggest according amendments to clarify this intention.

ESMA Proposed Amendment	Moody's Ratings Suggestion
Annex I. Section D.I ***5a. When a key element underlying a credit rating or rating outlook is an E, S, or G factor a credit rating agency shall additionally in its press releases or reports:*** ***i. identify prominently the key elements that were considered to be an E, S or G factor;*** ***ii. explain why these E, S or G factors were material to the credit rating or rating outlook according to the relevant methodology.***	***5a. When a key element underlying an initial credit rating or rating outlook is an E, S, or G factor a credit rating agency shall additionally in its press releases or reports:*** ***i. identify prominently the key elements that were considered to be an E, S or G factor;*** ***ii. explain why these E, S or G factors were material to the credit rating or rating outlook according to the relevant methodology.*** ***For subsequent rating actions, to the extent that a change to the credit rating or rating outlook is materially attributable to E, S, or G considerations, the accompanying press release or report shall:*** ***i. identify prominently the key elements that were considered to be an E, S or G factor;*** ***ii. explain why these E, S or G factors were material to the rating action according to the relevant methodology.***

[4] See the discussion under Question 4 in ESMA's Feedback Statement in the Final Report – Guidelines on Disclosure Requirements Applicable to Credit Ratings, starting from page 16.

Q10: Do you agree with the proposed change in Annex I Section A paragraph 9 of the CRA Regulation? If not, please explain.

We have no concerns with the proposed amendment.

Q11: Do you agree with the proposed change to Annex I. Section D.I paragraph 2a. of the CRA Regulation? If not, please explain why not.

We suggest clarification that the information about the process of validation refers to methodologies in general, so as to provide sufficiently general and understandable information about the CRA's processes. In contrast, a requirement that relates to each specific methodology would lead to overly technical and lengthy disclosures.

ESMA Proposed Amendment	Moody's Ratings Suggestion
<u>Annex I Section A, D.I, paragraph 2a</u> A credit rating agency shall accompany the disclosure of rating methodologies, models and key rating assumptions with guidance which explains assumptions, parameters, limits and uncertainties surrounding the models and rating methodologies used in credit ratings, including simulations of stress scenarios undertaken by the credit rating agency when establishing the credit ratings, credit rating information on cash-flow analysis it has performed or is relying upon, ***the process of validation,*** and, where applicable, an indication of any expected change in the credit rating. Such guidance shall be clear and easily comprehensible.	<u>Annex I Section A, D.I, paragraph 2a</u> A credit rating agency shall accompany the disclosure of rating methodologies, models and key rating assumptions with guidance which explains assumptions, parameters, limits and uncertainties surrounding the models and rating methodologies used in credit ratings, including simulations of stress scenarios undertaken by the credit rating agency when establishing the credit ratings, credit rating information on cash-flow analysis it has performed or is relying upon, ***the process of validation of its methodologies,*** and, where applicable, an indication of any expected change in the credit rating. Such guidance shall be clear and easily comprehensible.

Q12: Do you see merit in requesting a disclosure of the use of technological innovations such as Artificial Intelligence (AI) in the rating process?

We would suggest considering this question once that the EU's AI Act has been finalised, in an effort to understand the implications of this horizontal law on CRAs.