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FEEDBACK STATEMENT

**CESR's Consultation on Guidance on
Common Standards for Assessment of
Compliance of Credit Rating
Methodologies with the Requirements
set out in Article 8.3**



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I. INTRODUCTION

Background

1. The EU Regulation of the European Parliament and Council on Credit Rating Agencies (CRAs) was published in the Official Journal on 17 November 2009 and came into force on 7 December 2009. As a result, CRAs operating in the EU will need to apply for registration between 7 June 2010 and 7 September 2010 for their ratings to be used for regulatory purposes in the European Community
2. According to Article 21.3 (b) of the Regulation, CESR shall issue guidelines by 7 September 2010 on the common standards for assessment of compliance of credit rating methodologies to be conducted by competent authorities under the Regulation
3. To this end CESR issued a public consultation in May 2010 to seek comments from market participants on CESR's initial proposal on the common standards for assessment of compliance of credit rating methodologies with the requirements set out in Article 8.3.
4. Following the publication of the Consultation Paper, CESR set the 18 June 2010 as a deadline for market participants and other interested parties to send their comments.
5. CESR received ten responses to the Consultation, all respondents coming from the credit rating and banking sectors. In line with standard CESR's practices, responses to the Consultation were published on CESR's website <http://www.cesr-eu.org/index.php?page=responses&id=165> unless it was clearly specified by the respondent that they should remain confidential. Having considered the comments received, CESR has published its final Guidance on 30 August 2010.
6. This feedback statement outlines the main points which were made by respondents in the consultation process and explains the policy options which CESR decided upon. These policy options have been followed in its final Guidance (CESR/10-945).

II. GUIDANCE ON COMMON STANDARDS FOR ASSESSMENT OF COMPLIANCE OF CREDIT RATING METHODOLOGIES WITH THE REQUIREMENTS SET OUT IN ARTICLE 8(3)

1. General remarks

7. One of the respondents asked to avoid any oral request to credit rating agencies as part of ongoing supervision and rather to state questions in writing. In addition, one respondent asked CESR to clarify the timing for the submission of the requested information both at the stage of application for registration as well as on an ongoing basis.
8. *Having considered the feedback received, CESR has decided to amend the Guidance in order to add clarity (see paragraph 9).*
9. One respondent asked CESR to clarify the distinction between a material change to a methodology– which could represent a major departure from the current approach, but impact relatively few ratings– and a change that has a material impact –for example in terms of the number of affected ratings.
10. *Having considered the feedback received, CESR has decided to add the definition of material change consistently with Annex II to add further clarity.*



2. Scope of the guidance

11. One respondent noted that although paragraph 10 of the consultation paper seemed to draw on the language in Article 8.2, it should not be imported into the guidance published for Article 8.3. Furthermore, Article 8.2 prescribes that CRAs are required to “ensure that the credit ratings it issues are based on a thorough analysis of all the information that is available to it and that is relevant to its analysis according to its rating methodologies.”

12. *Having considered the feedback received, CESR has decided to amend the Guidance to address the issue (see paragraph 13).*

3. General information

Q1 - Do you agree with the approach outlined in sections 3 and 4 of the Consultation Paper? If not, please state your reasons.

13. One respondent proposed to amend paragraph 14(b) which refers to the process for developing and reviewing methodologies by deleting the “interactions between analysts developing methodologies and staff involved in the actual rating of the securities concerned, as well as the sign-off process”

14. *CESR has analysed this question and considers that the proposed amendment is not appropriate as competent authorities wish to know the nature of the interaction between analysts developing methodologies and the staff involved in the actual rating of the securities concerned.*

4. Detailed information

A. Demonstrating credit rating methodologies are rigorous

15. Some respondents showed concerns with the fact that paragraphs 15 and 16 of the Consultation Paper imply that CESR expects CRAs to organize themselves in a certain manner, and to adopt and apply methodologies in a certain way. As an example of that, the respondent considers that paragraph 15(a), which requires that credit rating agencies demonstrate that “they have appropriate controls in place between staff developing and updating rating methodologies and those responsible for issuing and monitoring ratings” will interfere with the internal organisation of CRAs and might not be consistent with analytical independence. They do not believe it would be sensible to develop methodologies without input from the analytical line since these are the staffs that are most familiar with the data and developments within their sectors.

16. *Having considered the feedback received, CESR has decided to amend its Guidance to add clarity (see paragraph 20).*

17. One respondent was of the view that paragraph 15(c) was not clear whether the “review function” refers to the review of methodologies themselves and those who develop them, or to the review of the work of the analysts who apply the methodologies in producing ratings.

18. *CESR has analysed this question and considers that CRAs are expected to have a function that reviews rating methodologies and a function that develops them. They should also have controls in place to ensure that the methodologies are well used and applied appropriately. Paragraph 22 of the Guidance has been amended accordingly.*

19. Several respondents noted that paragraph 15(d) made reference to methodologies being developed and reviewed “with appropriate access to all the information required to acquire a clear understanding of all factors relevant to the credit rating methodology...”. A similar concept regarding the sufficiency of information was also included in paragraph 15(b). Respondents thought that it would be appropriate for such provisions to include a materiality standard. They also believed



that CESR should acknowledge that responsibility for determining whether the available information is sufficient should lie with the CRA.

20. Paragraph 23 of the Guidance has been slightly amended to address the concern. However CESR expects the persons responsible for developing methodologies to have an understanding of all factors relevant to the credit rating methodology in question.

21. Regarding the information that CRAs need to submit in order to demonstrate that their rating methodologies are rigorous, one respondent believed that paragraph 16(a) should be deleted. They argued that the independent directors do not need to have an involvement in the development of the methodologies used by the CRA, but rather they had the specific task of monitoring that development. The independent directors should, in their view, have some degree of flexibility as to how they decide to discharge this function and the CRA should not establish policies that tell them how to.

22. Having considered the feedback received, CESR has decided to amend the Guidance (see paragraph 27) to clarify that independent directors need to have an involvement in the monitoring of the methodology development as opposed to an involvement in the development itself.

23. One respondent considered that paragraph 16 (n) of the Consultation Paper goes well beyond the requirements of Article 8.3. In particular, it is of the view that the EU Regulation does not require a CRA to engage in a process of consultation before changing its methodologies, and the steps that a CRA must take when changes are implemented were already set out in Article 8.6.

24. Another respondent noted that there was nothing in the EU Regulation that requires CRAs to engage in public consultations ahead of all criteria amendments and it does not believe it appropriate to introduce such a requirement through the guidance. There may be certain situations where it is not possible for a CRA to engage in an extensive consultation process, especially in the face of unexpected or rapidly changing events.

25. Having considered the feedback received, CESR considers that paragraph 41 of the Guidance does not require a consultation process before the publication of a change in rating methodologies. Therefore, it has decided not to amend the Guidance.

B. Demonstrating credit rating methodologies are systematic

26. One respondent suggested that the reference to “pre-defined credit assessment methodologies” in paragraph 17(a) of the Consultation Paper implied that CRAs must use particular types of modelling (such as credit modelling or credit scoring) which can be relied on to give consistent outcomes in all cases. In their view, it is not realistic to think that a rating committee can always produce identical ratings and suggested the deletion of such paragraph.

27. Having considered the feedback received, CESR has decided to amend its Guidance (see paragraph 42) to add further clarity.

C. Demonstrating credit rating methodologies are continuous

28. One of the respondents suggested that the wording in paragraph 19(a) of the Consultation Paper should be amended slightly to clarify that credit rating agencies should be expected to demonstrate that their rating methodologies remain globally consistent to the extent appropriate; and that paragraph 19(b) should be amended to specify that rating methodologies should be updated as necessary rather than frequently.

29. Having considered the feedback received, CESR has decided to amend its Guidance (paragraphs 50 and 51) to add clarity and address the concern.



D. Demonstrating credit rating methodologies are subject to validation based on historical experience, including back-testing

30. Some of the respondents considered that the requirements set out in paragraph 21 of the Consultation Paper should not be applied in such a way as to prevent new credit rating agencies from entering the market. Given the current oligopolistic structure of the rating market, they request that this line of thought is also applied to smaller players.

31. *CESR has analysed this question and made slight amendments to the relevant sections of the Guidance unless the requirements in question were provided by the EU Regulation.*