



2013 annual report on Credit Rating Agencies. March 2014.

ESMA has published on the 22th of February, its **annual report 2013 on Credit Rating Agencies (CRAs)** in the European Union. The report also outlines ESMA's work plan for 2014.

Analysis and registration of applications have increased substantially during 2013 and they are not expected to decline in 2014. ESMA assessed and approved the registration of three new and has certified one US-based CRA. Two further applications went through the full assessment process but were rejected by the Board of Supervisors, whilst three more were withdrawn during the registration phase. Four more applications are currently being assessed and a number of other potential applicants have informed ESMA of their plans. Applications rejected by the Board of Supervisors have struggled to demonstrate compliance with the regulatory requirements:

- outsourcing key operational functions to be carried out in non-equivalent third countries which may result in materially impairing the effectiveness of internal controls and the ability for ESMA to exercise its supervisory role, and
- new applicants will generally request one or several of the available exemptions from certain aspects of the Regulation but those exemptions will only be granted if applicants can demonstrate they have implemented other measures and procedures for the complying of the legal requirements.

ESMA's **supervision** has combined thematic investigations and on-going monitoring. ESMA has worked on the following thematic investigations: bank rating methodology, sovereign rating process, structured finance ratings, ratings publication controls and small and medium-sized CRAs. ESMA on-going supervision has largely consisted on the monitoring of the implementation of remedial actions defined in the thematic investigations.

We highlight, among the **policy documents**, the following: Guidelines on the scope of the Regulation nº 462/2013, of 21 de mayo, amending Regulation nº 1060/2009 on CRAs (called CRAs 3, a discussion paper on the implementation of the Regulation in order to issue three draft Regulatory Technical Standards that ESMA should submit to the European Commission before June 2014.

The 2013 annual report includes CRAs **supervision and policy work plan for 2014**.

ESMA's **supervisory activities**, as indicated before, have consisted of thematic investigations and ongoing supervision.

Thematic investigations have been referred to:

- Bank rating methodology. The investigation took place in 2012 but remedial action plans for each CRA were set in place in the first quarter of 2013 and monitored through the year as part of on-going supervision. This remedial actions refer, inter alia, to: setting up policies and procedures in cases of change of methodologies, models and assumptions; new processes for ensuring the quality of information used; updating the

methodology to include qualitative and quantitative factors; and the installation of new links to their websites so that users can have easy access to historical versions of rating methodologies.

- Sovereign rating process. ESMA conducted over 60 onsite interviews at the three largest CRAs to assess their corporate governance, management of conflicts of interest, adequacy of resources, and confidentiality controls associated with the sovereign rating process. The result showed that the actual failings or potential risks identified might compromise the independence of the rating process and the quality of the credit rating: i) participation in the sovereign rating process of senior management, of the independent review function and of other functions; ii) deficiencies in the way confidential information is managed, in particular, how access to information on upcoming rating actions on sovereigns is controlled; iii) delays in the notification to rated entities about upcoming rating actions and in the publication of sovereign ratings; iv) the doubt appropriateness of mechanisms to assess the adequacy of resources. Individual remedial action plans were set by ESMA for each the CRAs investigated that are now being implemented.

- Structured finance ratings. ESMA announced in 2013 and is now carrying out specific supervisory work at four large CRAs on the organization and processes of the oversight function of the ratings of structured finance, specifically on Residential Mortgage Backed Securities (RMBS) asset class which is the most representative of the overall structure finance instruments market, through a selected sample of European Union RMBS transactions.

- Ratings publication controls. ESMA carried out an assessment on publication of credit ratings on the website of one particular CRA with a view to know the cause of recurrent delays in updating the information on the ratings. The investigation identified a number of issues to be improved: presentation of changes to ratings on websites in a timely way, transparency and monitoring of the content of the website, adequacy of IT systems, tools to control the dissemination process, and clear allocation of responsibilities in the process.

- Small and medium-sized CRAs. ESMA began an investigation into 14 smaller and medium-sized CRAs with the aim of analyzing compliance with the regulation and business strategy. The investigation included a combination of desk-based assessments focused on the answers to a supervisory questionnaire (March 2013) and subsequent on-site inspections especially concerning to: the independence of board members and managers/compliance and internal functions; the clarity of reporting lines; and appropriate disclosure of methodologies and changes. ESMA will conclude the research next July.

ESMA on-going supervision has consisted, as addressed above, on the monitoring of the implementation of remedial actions defined in the thematic investigations. Also, ESMA has issued endorsements of credit ratings issued in third countries and assessments of the new procedures and internal controls put in place by CRAs and of the requirements to notify issuers. ESMA has reviewed the contracts in place between issuers and CRAs and relationships board members of the CRAs and rated entities in order to prevent potential conflicts of interest. ESMA aims to increase transparency of its supervisory actions and, with that purpose, ESMA has published a report on findings following the thematic investigation that has conducted on the sovereign rating process, has had regular (even informal) communications with the CRAs and has held a roundtable discussion with industry. Cooperation with competent authorities has been reinforced with the establishment of supervisory colleges - which met for the first time in November 2013- for the effective supervision of the three largest internationally active CRAs (Fitch, Moody's and Standard & Poor's).

Besides the **policy documents** highlighted above, ESMA has issued other interesting reports. Thereby, the annual publication of the list of registered CRAs indicating their total market share, and a technical advice to the European Commission on the feasibility of a network of small and medium-sized CRAs. ESMA contributed with IOSCO to the drafting of the recommendations for supervisory colleges and to the issuing of the report regarding transparency and competition, and is now cooperating in the review of the IOSCO Code of Conduct for CRAs. ESMA has also taken part in the ESAs final report on mechanistic references to credit ratings in the

ESAs' guidelines and recommendations. ESMA published technical advice on the equivalence between the European Union regulatory regime for CRAs and the respective legal and supervisory frameworks of Argentina, Brazil, Mexico, Hong Kong and Singapore.

ESMA **supervisory work for 2014** will include the completion of the thematic investigations on structured finance ratings and on small and medium-sized CRAs that had not been included in the research carried out in 2013. ESMA will conduct investigations on: 1) how CRAs review and validate their rating methodologies with the aim of delivering best practice standards for the industry to enhance the effectiveness of CRAs' internal review function and the quality of assigned ratings; 2) the rating process (continuity of activities, independence of the decision-making process and confidentiality of rating information); and 3) IT system and controls systems. On-going supervision, although new priorities might emerge and change the agenda, will be focused on a specific assessment on CRAs' compliance with the new requirements of the CRA3 Regulation.

ESMA **regulatory work for 2014** will include: 1) three draft Regulatory Technical Standards to implement the CRA 3 Regulation, respectively, on information on structured financial products, on the European Platform Rating, and on the periodic reporting on fees charged by CRAs; 2) the report to the European Commission regarding the possibility of establishing one or more mappings of the credit ratings published by the European Platform Rating; and 3) several other technical advices (review of the situation in the credit rating market for structured finance instruments in the credit rating market -particularly for re-securitisations- and review of the situation in the overall credit rating market, removing references to ratings that lead to an exclusive reliance on them, automatic tools that allow investors to assess for themselves the credit risk of issuers and financial instruments, and appropriateness of developing an assessment of the creditworthiness of the European sovereign debt). ESMA, in cooperation with the ESAs, will publish the following report: the final draft on Implementation Technical Standards on the mapping of the External Credit Assessment Institutions' credit assessment, and the guidelines and recommendations on the supervision of reliance on ratings by financial intermediaries.

If you want to read the ESMA Credit Rating Agencies annual report 2013, please, do click on: http://www.esma.europa.eu/system/files/2014-151_cra_annual_report_2013_and_work_plan.pdf