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on the European Court of Auditors' Special Report N°22/2015 (2014 Discharge): EU supervision of Credit Rating Agencies - well established but not yet fully effective

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Introduction and background

Credit rating agencies (CRA) issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants. The global financial crisis in 2008 focused attention on the role of CRAs and the impact of their ratings on financial markets.

The European Securities and Markets Authority (ESMA) was established on 1 January 2011 as part of the European System of Financial Supervision (ESFS). The ESFS comprises ESMA, the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) which, together with the national supervisory authorities (NSAs), the European Systemic Risk Board (ESRB) and the Joint Committee of the European Supervisory Authorities form the current European supervisory architecture. ESMA's main purpose is to protect public interest by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets. In June 2015, ESMA supervised 23 credit rating agencies registered in the EU.

The activities of ESMA are based on the Credit Rating Agency regulation[1] (CRAR). Its principle objective is to protect investors and ensure the stability of financial markets in the EU. The regulation governs the preparation processes and methodologies for generating credit ratings. CRAs must use rating methodologies that are 'rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing'. CRAs must disclose their rating methodologies and the critical assumptions used. It also contains a significant level of prescriptive detail on how CRAs should manage conflicts of interest.

The audit approach

The audit of the European Court of Auditors (ECA) examined if ESMA's registration process and supervision of CRAs was effective. In particular, the ECA analysed whether

- the registrations of all possible CRAs had been done correctly and efficiently;
- ESMA had developed and implemented a sound planning and risk assessment for its supervisory activities;
- the implementation of the supervisory framework captured the problems revealed in the CRAs' business13, including those related to the independence of rating boards and preventing conflicts of interest; and
- ESMA and the CRAs publish sufficient and value adding information to its stakeholders.

[1] 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), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

ECA conclusions

- ESMA laid down good foundations for effective supervision of the CRAs in the EU in a short period of time;
- ESMA has well-developed registration procedures for CRAs; nevertheless, the procedure remains cumbersome, due to the split into completeness and compliance phases as required by the regulation; credit rating methodologies should be rigorous, systematic, continuous and subject to validation; however, the evidence audited supported mainly the rigorousness of the methodologies;
- The current rules of the Eurosystem[1] do not guarantee that all ESMA-registered CRAs are on an equal footing; the Eurosystem currently accepts ratings issued by four ESMA-registered CRAs as external credit assessment institutions[2] (ECAI) under the Eurosystem credit assessment framework[3].; in order to have their ratings accepted by the Eurosystem, CRAs must fulfil extra operational criteria in addition to being registered or certified by ESMA; this approach creates a two-tier market structure, in which small CRAs cannot compete on an equal footing with larger CRAs;
- ESMA has a well-established procedure for risk identification; however, the lack of documentation trail creates difficulties in understanding the rationale for reprioritising certain risks; ESMA did not investigate all high-risk areas in a sufficient and consistent way; the ECA found that the supervision resources did not adequately keep up with the increasing requirements in the regulation;
- ESMA's supervision guidelines do not define the exact types of ongoing supervisory tasks to be undertaken, nor do they provide information regarding the frequency of these tasks; ESMA does not have adequate internal standards for documenting supervisory work, and it is difficult to track ongoing supervisory work that has been performed or the analysis and conclusions derived from it;
- ESMA does not have a procedure to examine the new methodologies or material changes to methodologies notified by the CRAs;
- ESMA did not sufficiently examine certain potential conflicts of interest; although ESMA receives a lot of information from the CRAs regarding the trading activities and securities holdings of their staff, it did not examine this information in a structured way;
- The CRAs' general disclosure is not always at the highest standard and that disclosure, especially when it concerns methodologies and descriptions of models and key rating assumptions, does not always enable potential users of credit ratings to perform their own due diligence;

[1] The Eurosystem is the monetary authority of the euro area. It comprises the European Central Bank and the national central banks of the Member States. The Eurosystem's primary objective is maintaining price stability. It also aims to safeguard financial stability and promote European financial integration.

[2] External Credit Assessment Institutions are CRAs, which provide ratings and related probabilities of default for regulatory purposes.

[3] The Eurosystem credit assessment framework (ECAF) mitigates the credit risk of collateral used in monetary policy operations, together with appropriate valuation and risk control measures. Collateral is legally watertight, valuable liquid property that is pledged by the recipient as security on the value of the loan.

- ESMA neither discloses information sufficiently, nor performs adequate checks on the data reported to the online central depository (CEREP);
- ESMA's website lacks certain useful information for CRAs, potential new market participants and credit rating users; the website is not well structured and the available information is difficult to find.

ESMA's replies

- The documentation that was received as part of the registration processes allowed it to fully assess all the requirements set forth in the CRAR and in the regulatory technical standards on methodologies; evidence of ESMA's approval process can be found in ESMA's internal correspondence;
- The outcome of ESMA's registration process has no influence on the rules governing the acceptance of the credit ratings in the Eurosystem;
- ESMA made a conscious decision to be a risk-based supervisor; the ESMA risk-based framework is built around 13 risk indicators and on an annual basis ESMA conducts a strategic exercise to define the annual supervisory work plan that sets priorities and actions for the year ahead. Since 2012, in total 39 times a risk indicator was identified as high risk for high impact CRAs;
- ESMA believes that so far its documentation and monitoring tools have been effective and allowed ESMA to retain the relevant information supporting its decision making process;
- While ESMA acknowledges that until recently it did not have a formal procedure for examining the notifications of material changes to existing methodologies, ESMA did have a procedure describing in detail the recording and monitoring activities that the CRA Unit needs to follow concerning the notifications of material changes to the conditions for initial registration, which includes the issuance of a new type/class of credit ratings;
- ESMA stresses that the entire CRAR is designed to address conflicts of interests and therefore, ESMA focused significant supervisory efforts on assessing the measures put in place by CRAs to avoid conflicts of interest;
- ESMA regularly conducts cross-CRAs assessments to verify the harmonisation in the implementation of certain requirements of the CRAR, such as the supervisory work conducted by ESMA on the compliance of CRAs issuing sovereign ratings with the new disclosure requirements introduced by the 2013 amendments to the CRA regulation;
- While CEREP does not include an exhaustive list of all possible statistics ESMA would like to stress that only data that passes extensive validation checks embedded in the data collection tool (50 checks at level 1 and 50 checks at level 2) and systematic completeness checks, is stored in the database and ultimately made available on CEREP.

ECA recommendations

1) During the registration process, ESMA should adequately document its assessment of all the regulatory requirements regarding the credit rating methodologies;

2) ESMA should enhance the traceability of the risk identification process. ESMA should maintain a log of the changes to the risk level and document the prioritisation of risks together with reasons; ESMA should follow up all the high-risk areas, which would benefit from further supervisory work.

3) ESMA should regularly update the supervisory manual and handbook; it should establish internal guidance for the effective documentation of the investigations so as to demonstrate and ensure that all conclusions are supported by adequate analyses of the evidence; it should also put in place a dedicated supervisory IT tool that would improve knowledge sharing, clarify the ownership of tasks, facilitate the review of the work done, and improve communication within the supervisory teams.

4) ESMA should examine all important aspects of the design and implementation of CRA methodologies which have not yet been covered;

5) ESMA should examine in a structured manner the systems put in place by the CRAs for dealing with conflicts of interest, and in particular those relating to rating analysts' trading activities and financial transactions;

6) ESMA should work on further improve and align disclosure practices across the CRAs;

7) ESMA should monitor and improve the information content of CEREP disclosures based on best practices for disclosing ratings performance;

8) ESMA should publish all applicable legislation and relevant documents and make the website more user-friendly.

<u>Recommendations by the rapporteur for possible inclusion in the 2015 Commission discharge report</u>

The European Parliament:

- Stresses that the objective of the CRAR is to introduce "(...) a common regulatory approach in order to enhance the integrity, transparency, responsibility, good governance and independence of credit rating activities, contributing to the quality of credit ratings issued in the Union and to the smooth functioning of the internal market, while achieving a high level of consumer and investor protection." (Article 1 of the CRAR);
- Recognises that the ECA and EMA agreed on many aspects of the audit and recommendations;
- Welcomes that the ESMA laid down good foundations for effective supervision of the CRAs in the EU in a short period of time; notes however the ECA considers the procedure to be cumbersome, due to the split into completeness and compliance phases as required by the regulation;
- Shares the Court's opinion that during the registration process, ESMA should adequately document its assessment of all the regulatory requirements regarding the credit rating methodologies, evidence of the approval process should not only be stored in internal correspondence but in dedicated case files;
- Welcomes that ECA and ESMA agree on ESMA's risk-based approach; the risk identification process should be transparent, comprehensible and traceable;

- Is of the opinion that all investigations should be properly documented so as to demonstrate and ensure that all conclusions are supported by adequate analyses of the evidence; notes that too this end the Court recommends to put in place a dedicated supervisory IT tool; notes ESM's argument that its current monitoring tools have been effective; however, remains convinced that a dedicated IT tool would be the best way to manage information in transparent, comprehensible, traceable manner bearing in mind normal rates of stff turn-overs; therefore asks ESMA to foresee the introduction of such an IT tool in its budgetary planning;
- Recalls that one of the purposes and responsibilities of the CRAR is to ensure independence and to avoid conflicts of interests (see annex 1 of the CRAR); believes therefore that CRAs also verify rating analysts' trading activities; nevertheless ESMA should supervise, in a structured manner, the systems put in place by the CRAs for dealing with conflicts of interest;
- Points to the provisions of Article 23 of the CRAR which stipulates: "In carrying out their duties under this Regulation, ESMA, the Commission or any public authorities of a Member State shall not interfere with the content of credit ratings or methodologies."; the implementation of CRAs' methodologies can therefore only be monitored, once the registration was completed, by ongoing supervisory procedures;
- Agrees that ESMA should examine all important aspects of the design and implementation of CRA methodologies which have not yet been covered; is concerned that this task cannot be fully performed due to a lack of resources;
- Regrets that the current system does not guarantee an effective protection of the markets in the event of a leak and calls ESMA to improve its control system to prevent and counter those actions that can lead distortions in the markets;
- Regrets that the current rules of the Eurosystem do not guarantee that all ESMA-registered CRAs are on an equal footing; calls in the European Central Bank and the European legislator to remedy the situation as soon as possible;
- Understands that the central repository will be integrated in the European rating platform (Article 11 a CRAR) created in 2013 and for which the work is ongoing; ask ESMA to ensure the soundness of data reported by CRAs;
- Calls on ESMA to further improve and harmonise disclosure practices across the CARs;
- Welcomes EMAS' intention to further improve its website and publish, in particular, all applicable legislation and relevant documents and make the website more user-friendly.
- Notes that some terminology used in the CRAR (i.e. methodology) may leave room for interpretation and could therefore have a negative bearing on the implementation of the regulation; calls therefore on ESMA and the ECA to transmit to the Commission and the legislator a list legislative provisions which could benefit from further clarification;