Date: February 19th, 2016

To ESMA
Submitted via Mail

Reference: ESMA Discussion Paper on validation of rating methodologies

Dear Sir,

We welcome ESMAs Discussion Paper on the validation of CRA rating methodologies and the techniques proposed by ESMA. This Discussion Paper is based on ESMA's review of current practices of CRAs, which shows that CRAs apply a wide-range of different techniques to a differing degree depending on the methodologies being validated. The diversity of approaches reflect the different market segments, scopes of the methodologies as well as analytical approaches and choices by the CRAs in defining relevant quantitative and qualitative rating criteria.

Market Segment	**Comment on size of market and default experiences**
Sovereigns	Around 200 Sovereigns are currently rated. The number of Sovereigns is limited and the default experiences equally. The IMF concluded in its Global financial Review dated October 2010, that CRAs managed to properly rank sovereign risks.
Sub-Sovereigns	The institutional set-up within a country on the relations between the top-level sovereign and its constituents varies substantially (as the degree to define and collect taxes of a Municipality depends on the country of residence). Default evidence is, for the vast majority of geographies, non-existing.
Covered Bonds	The legal regime on Covered Bonds varies across Europe – this market can't be aggregated into a single market segment. Given the high regulatory framework on covered bonds already in place (eg double-recourse structure), historical default evidence is virtually non-existing.
Insurances	Given the regulatory regime on insurances, defaults are equally non-existant as supervisors would step-in earlier.
Banks	The regulatory regime on banks has substantially evolved in recent years. But, defaults by banks have historically remained low as often Sovereigns stepped-in. We note that BIS proposes that CRAs provide rating assessments excluding potential Sovereign support. While we note that some CRAs may exclude sovereign support already, we think that the principle of non-interference into a CRA's methodologies as embedded in the EU CRA Regulation should prevail.

Global large non-financial issuers	The large global non-financial issuers together with the Stock listed companies correspond to a very limited share of the companies in a country. The number of ratings per geography (jurisdiction) is therefore limited.
SME Ratings	Some CRAs provide a wide coverage of SME ratings in specific geographies. Given the high number of outstanding ratings, some statistical performance analysis could be done.
Structured Finance	Taken at an aggregate level, this market segment would be suited for quantitative techniques. With reference to the Mapping of SF Ratings, we note that the performance of CRAs has substantially differed according to market segments and/or geographies. Disaggregating this market leads automatically to reduced number of ratings and number of defaults.

Based on the above high-level analysis of the main market segments, we think that the vast majority of rating methodologies fall into the category of "Low Quantitative Evidence" – the benefits anticipated by ESMA for the "Sufficient quantitative evidence" cases will therefore be limited to very few cases.
Not surprisingly, during the Open Hearing held on January 25th in Paris on this topic, CRAs voiced concerns regarding the ability to run the proposed statistical tests (this argument being reflected in the Discussion Paper)
We understand that the proposed validation techniques should apply equally to new methodologies and to the revision of methodologies:

- by virtue of the CRA Regulation and the mandatory registration of a CRA before the issuance of a rating, with respect new CRAs (and new methodologies), historical evidence measured in terms of assigned ratings will always be 0
- with respect to the review of existing methodologies, this may go beyond the modification of quantitative (ratio driven) criteria and may introduce additional new factors (not considered earlier and therefore no data being collected on this aspect). By modifying a methodology, issued ratings base on a former methodology may be considered obsolete.

This Discussion Paper may lead to the issuance of a specific guidance to CRAs by ESMA, in line with the recent recommendation from the European Court of Auditors report on the EU Supervision of CRAs. Such guidance would be beneficial to CRAs in terms of outlining ESMAs expectations with regard to statistical methods, approaches, thresholds and potential further actions. We think that these options should be duly evaluated and considered by CRAs – but none of these can be made compulsory given the diversity of market segments covered by rating methodologies. Additionally, the list of proposed techniques should not be considered as exhaustive, as new techniques may be developed or other techniques may be used.

We remain at your full disposal for any clarification or further information.

Thomas Missong — Adolfo Estevez Beneyto
EACRA President — EACRA Secretary General

On behalf of the following ESMA registered and certified CRAs: AM Best, ARC Ratings, Assekurata, Axesor, Capital Intelligence, Cerved Rating Agency, Creditreform Rating, CRIF, Dagong Europe, Egan-Jones Ratings Company, Euler Hermes Rating, Kroll Bond Ratings and Scope Ratings.

1. Do you agree with ESMA's view regarding the discriminatory power of methodologies?

We think that "the discriminatory power of a methodology relates to the ability to rank order the rated entities" creditworthiness using an established system of rating categories. A rating methodology may therefore not be based solely on defaults events.

As mentioned in our introduction, we think that the "sufficient quantitative evidence" case is rather the exemption than the rule.

With reference to §18 of the consultation, we note that ESMA considered that in some specific segment enough evidence was available to perform discriminatory tests, while one or more CRAs mentioned that this task was challenging. In case of such divergent views between ESMA and a CRA, we would welcome ESMA's specific "technical advice" on how to address the quantitative evidence. The identified approach should be proportionate to the scope of the rating methodology as well as to the usage of CRAs by market participants.

6. Do you agree with ESMA's view regarding the predictive power of methodologies?

With reference to §41 of the Discussion Paper, we think that ratings are usually ordinal measures of credit-risk. The ordinal nature of ratings means that ratings are being ranked relative to each other and not against a pre-defined level of events (eg. Probability of default).

During the open hearing on January 25th, several CRAs mentioned that tying methodologies to specified levels of default may modify the nature of the rating product and may raise expectations from market participants regarding the specified levels.

With reference to §44 of the Discussion Paper, ESMA argues that tiding methodologies to creditworthiness-related expectations is based on the expectation of users of ratings and may feed into mapping of ECAI ratings. We instead think that ratings are a well established "product" known to financial market participants for several decades. We note that until recently the mappings were done on a highly pragmatic level: we note that the Capital Requirements Regulation (CRR) uses 6 credit quality steps under the Standardized Approach for Credit Risk and stress that the CRR itself does not define the probabilities of default associated with each credit quality step – only through the ITS on the mapping of ECAIs corporate ratings, such a correspondence table is being introduced. We think that the validation of a rating methodology should be separated from the mapping of ECAI ratings as these two exercises' have different objectives and targets.

7. Do you agree that statistical measures of predictive power increase the quality of validation of CRAs methodologies and should be performed by the CRAs?

We think that such test should be applied only where a rating methodologies specifically targets probabilities of default.

13. If ESMA establishes that there is a need for further guidance to the industry, should this guidance also cover the demonstration of predictive power of methodologies related to creditworthiness measures other than default probabilities?

We welcome this Discussion Paper on the validation of rating methodologies as it shares ESMAs findings and outlines potential approaches. We think that this "catalogue" of approaches should be considered by CRAs in the process of the validation of rating methodologies. In view of the variety of market segments and the overall limited quantitative evidence, we think that the intended guidance should remain flexible in nature.

14. Do you agree with ESMA's view regarding the historical robustness of methodologies?

We are of the opinion that historical robustness measures should be applied carefully when the rating portfolio has a lower number of observations - calculating transition matrixes on the basis of eg. 5 ratings don't derive any meaningfull statistical information and may be misguiding.

18. Do you agree with ESMA's view regarding the validation of methodologies with limited quantitative evidence?

With reference to § 54 of the Discussion Paper, we agree with ESMA that CRAs should establish internal guidelines regarding the validation of rating methodologies and whether these should be done under Article 7 of the RTS on rating methodologies or rather under Article 8 of that RTS. Such internal guidelines could take into account a.o. the number of default observations.

19. Do you agree that CRAs should, as a first step, investigate data enhancement in validating methodologies with limited quantitative evidence?

While we welcome ESMAs suggestion regarding data enhancements, we think that the proposed approaches have all important limitations:

- Expanding the data sample with the use of third party data (eg ratings issued by another CRA) may not necessarily improve the information base of a CRA – ratings issued by another CRA are based on that CRAs methodology and need therefore to be validated by that CRA only.
- Combining asset classes to perform joint validation assessments, leaves out the specificities identified for each asset class.
- Hypothetical transactions are by definition hypothetical and therefore equally subject to expert opinion. Additionally, creating hypothetical ratings on a large scale may be associated with very high administrative costs to the CRA.

20. Do you agree that CRAs should, as a second step, investigate measures that may enable them to perform statistical tests to demonstrate the discriminatory power of their methodologies?

We welcome the additional measures proposed by ESMA but note again important limitations:

- The use of a relaxed "default definition" does not trigger more Defaults;
- Combining rating categories can be done only if the combination is made within rating categories with similar risk (e.g. notches).

22. Do you agree that the transition (migration) matrices and benchmarking are the minimum measures that a CRA should use as part of its validation processes for methodologies with limited quantitative evidence?

With respect to the benchmarking of a CRA rating to ratings from other CRAs, we think that this exercise is interesting but should be done very carefully as each CRA uses its own rating methodologies and rating scales – benchmarking CRAs ratings to each other may create a self-referencing system and "outlayers" would be eliminated over time, leading to a

harmonisation of rating methodologies across CRAs and thereby reducing information content of several ratings to users. In view of the performance of SF ratings during the global financial crisis, we recommend that each CRA is assessed at its own merits. Moreover, the rating portfolio of a new CRA does often not overlap with that of other existing CRAs.
With respect the benchmarking to credit default swaps spreads or bond yields, we note that these two measures take into account other factor than only creditworthiness – these may be driven amongst others by market liquidity.

25. Do you agree that thresholds should be set for the quantitative validation techniques?
We understand that the thresholds should relate to anomalies highlighted by back-testing. In view of the different distribution of ratings per market segment, anomalies will differ and can't be harmonized across all market segments and CRAs. Quantitative thresholds may prove to be difficult to set and therefore expert judgment on qualitative factors should be an alternative approach.

26. Do you agree that the Internal Review Function should decide on these values?
We think that the threshold should be set according to each CRAs procedures for the establishment (or review) and approval of rating methodologies

27. Do you agree that predefined actions should be defined by the CRAs when the thresholds are met?
"Predefined actions" could include a wide range of topics (such as further analysis of an identified topic) and may not necessarily lead to a change of a rating methodology.

About EACRA

The European Association of Credit Rating Agencies ("EACRA"), registered in Paris, was established in November 2009. The Members of the Association currently originate from 12 countries and include the following companies:

ESMA registered Credit Rating Agencies
A.M. Best Europe - Rating services Limited (AMBERS) is a subsidiary of A.M. Best Inc who have been providing ratings to the Insurance Sector since 1899. AMBERS' rating coverage includes regional, national and global insurers located throughout Europe, the Middle East and Africa.
ARC Ratings is an international rating agency with a presence in 11 countries on four continents. ARC is registered with ESMA and results from a partnership of 5 leading rating agencies operating in India, Brazil, Sub-Saharan Africa, Malaysia and Europe. This partnership has over 6000 rating clients and 400 ratings staff, giving ARC global coverage as well as vital local knowledge

Assekurata Assekuranz Rating-Agentur is the first independent German rating agency that has specialized on the quality evaluation of insurance companies

Axesor: The first Spanish Rating agency registered with ESMA. Specialized in the middle market segment, with ample coverage of the Spanish corporate market.
Capital Intelligence (CI) offers independent rating opinions on financial institutions, corporates and governments in a wide range of countries, especially the emerging markets of Asia, Europe and the Middle East.

Cerved Rating Agency: Italian Credit Rating Agency recognized ECAI by Bank of Italy

Creditreform Rating: based in Germany, a company of the Creditreform Group that is European market leader in the sector of business information was founded 2000 and is specialised in ratings of companies, bonds, funds and structured finance products across Europe.

CRIF: International Credit Rating Agency based in Italy providing both solicited and unsolicited Corporate ratings.

Dagong Europe Credit Rating, headquartered in Milan, was registered by ESMA in June 2013. It is owned by Dagong Global Credit Rating. Dagong Europe provides European and Asian investors with credit opinions on financial institutions (including insurance companies) and non-financial corporate.

Euler Hermes Rating is a European rating agency located in Hamburg, Germany. We offer credit ratings and research about debt capital market instruments of corporates of all sorts of industries, project finance ratings and credit portfolios. Euler Hermes Rating is a member of Euler Hermes Group and a company of Allianz

Scope Ratings is an independent credit rating agency founded in Berlin, Germany, in 2002. The company is specialized in ratings and analysis of corporate bonds, financial institutions, structured finance, and alternative investment funds (AIF).

ESMA certified Credit Rating Agencies

Egan-Jones Ratings Company ("EJR") is a leading Rating Agency in the United States with a strong track record for being early and correct. We publish several hundred qualitative and quantitative reports each month. Our reports are not just maintenance but focus on locating and reporting on active situations. EJR's track record is very compelling as we have shown an exceptional record for anticipating the direction of future credit action.

Kroll Bond Rating Agency (KBRA) was established in an effort to restore trust in credit ratings by creating new standards for assessing risk and by offering accurate, clear and transparent ratings. KBRA is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (NRSRO). In addition, KBRA is recognized by the National Association of Insurance Commissioners (NAIC) as a Credit Rating Provider (CRP).

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Credit Rating Agency (CRA) Limited operates in Zambia and is licensed by the Securities and Exchange Commission of Zambia. It commenced operations in September 2014 and is the first active credit rating service provider in Zambia. CRA rates private and public sector entities, and debt instruments.

Fedafin AG : is registered with the Swiss Financial Markets Authority and acts as rating provider to the Swiss stock exchange

JCR Eurasia is an international credit rating institution based in Turkey.

National Rating Agency (NRA) is one of the leading independent rating agencies in Russia. As of today National Rating Agency has assigned ratings to over 750 leading Russian and international companies.

RusRating is a credit rating agency based in Moscow, with sister agencies in Armenia and Kazakhstan. It is accredited with the Ministry of Finance of the Russian Federation.

Other EACRA members

Ellisphere: French leader in business & marketing information and credit management solutions, providing a large range of tools and solutions to secure companies' supply chain financing and improve their development.

Informa is the Marketing, Financial and Business Information leading company in Spain, offering currently more than 3.7 million online scores on Spanish companies

The Members of the Association have very different business models (issuer-pays, investor-pays, hybrid and special models) while assigning ratings. Since January 2014, all ESMA registered or certified CRAs are considered ECAIs across the whole European Economic Area.
Reference the Article 8 d on the use of multiple CRAs and ESMA's report dated December 18th , 2015, all EACRA members registered with ESMA have less than 10% market share in the EU (measured against revenues).