European Securities and Markets Authority

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ESMA 2013 CRA SUPERVISION AND POLICY WORK PLAN

I. Introduction

The European Securities and Markets Authority (ESMA) is publishing its 2013 CRA Supervisory and Policy Work Plan with the aim of enhancing the transparency of its actions regarding credit rating agencies (CRAs) in the European Union (EU).

I. High-impact and risk-based supervision: ESMA's 2013 plan for CRA supervision

1. The enhancement of the integrity, transparency, responsibility and good governance of CRAs and the reliability of credit ratings have been key drivers of ESMA's supervisory activities since it took on this role in July 2011. ESMA's supervisory approach to CRAs plays a critical role in helping ESMA to achieve its over-arching mission of contributing to the smooth functioning of the EU's internal market and ensuring a high level of consumer and investor protection.

2. In carrying out its mission ESMA is required to conduct high impact and risk-based supervision, to make timely interventions, use appropriate tools to ensure that CRAs comply with the CRA Regulation[1], and appropriately allocate its resources.

3. All of these aspects guide ESMA's preparation of its work plan for the supervision of CRAs that is approved annually by its Board of Supervisors.

4. The primary aim of this paper is to describe ESMA's 2013 supervision plans for one certified CRA and the 19 CRAs that are currently registered with ESMA.

II. Supervision of CRAs: objectives for 2013

5. An essential building block in the delivery of our supervisory mandate is the development of a credible regime that encourages registered entities to embed good practices internally and to ensure that they meet the requirements of the relevant Regulation. In order to achieve this, ESMA's supervision must be engaged and intrusive. ESMA needs to communicate and be transparent about its supervisory activities so that the industry is clear about the standards they are expected to meet.

   High-impact supervision

6. In 2012, the main focus of ESMA's supervision activities was aimed at scrutinising CRAs' internal processes and controls and requiring CRAs to take action to improve controls where we found weaknesses. In 2013, we will build on this approach by focusing on particular areas where we can continue to raise standards. We will take firm and prompt supervisory action where we see breaches

[1] Regulation EC (No) 1060/2009 as amended by Regulation EC (No) 513/2011

and risks, using all the tools at our disposal, including mitigation plans, Dear CEO letters, published guidance, and enforcement.

Transparency of ESMA's actions

7. ESMA has set itself an objective of being transparent in its regulatory activities, within the limits of the need to ensure the confidentiality of individual firm information. We intend to issue public reports on the findings of thematic reviews when these have generic relevance to the CRA industry as a whole. As an example, the findings of the 2012 banking methodology thematic review will be published in ESMA's CRA Annual Report regarding the compliance of CRAs with the Regulation (expected publication end March 2013). ESMA will also publish industry guidelines on the scope of the Regulation which is aimed at firms operating at the boundaries of the Regulation.

Preventative supervision

8. ESMA intends its supervision to be forward-looking and preventative, identifying and anticipating risks before they materialise. With the aim of identifying risks in a timely fashion, we have established a cycle of frequent engagement with CRAs and we will further enhance our risk analysis framework, which helps in prioritising our supervisory actions.

III. 2013 supervisory activities

9. A combination of on-going desk-based supervision and targeted on-site inspections will allow us to meet our objectives.

a) On-going and proactive supervision

10. Firstly, our 2013 plan establishes a cycle of engagement with CRAs which will assist ESMA in focusing on the riskiest CRAs, while maintaining an adequate level of oversight of the CRAs that pose less risk to its regulatory objectives. This will consist of regular contact that reflects each CRA's risk. In these regular contacts ESMA will typically raise compliance concerns and risks identified by the assessment of the periodic reporting data received by ESMA, market intelligence, complaints, etc. Depending on the size and structure of the CRA, the key individuals with whom we will typically engage would be the CEO and other directors, the independent directors of the Board and heads of internal review, compliance and risk and senior IT management.

11. Secondly, the 2013 plan sets out a schedule of onsite visits to 13 smaller and medium-sized CRAs over the year. This is in order to meet ESMA's obligation to inspect all registered CRAs by July 2014, but more importantly, to assess their compliance and control functions along with their business strategy, which we have identified as the main areas of regulatory risk posed by these CRAs.

b) Thematic assessment of risks on thematic or individual basis

12. In addition to our day-to-day supervision, the 2013 plan sets out ESMA's commitment to carry out a minimum of two reviews into different aspects of the rating process of sovereign and structured finance ratings. These will be conducted either across a number of CRAs or as a *deep-dive* into a single CRA with a particularly large market presence in the rated product sector.

13. ESMA's concerns with the structured finance sector arise out of the observation that, despite the dramatic change in the structured finance market following the crisis and the sharp decrease in new issuance volumes, we continue to have concerns with this product area. The outstanding volumes remain at high levels and structured finance products have experienced the highest ratings transitions and defaults during the last few years.

14. Regarding sovereign credit ratings, ESMA's concerns stem from the growth in their volatility over the past 12 months, as compared to historical trends, the importance of sovereign ratings from a credit market and financial stability perspective, and the cascade impact on other rated entities and products.

15. Finally, through our on-going supervisory activity, and following our first-step review which took place Q4 2011 to Q2 2012, we have noted that IT risk is generally high across all firms. In 2013 ESMA will carry out a review of the effectiveness of the IT structural and procedural controls around the publication of credit ratings in one of ESMA's' registered CRAs, following a number of deficiencies that had been identified during 2012.

c) Following up on 2102 investigations and thematic reviews

16. The 2013 plan includes the allocation of resources to monitor the significant amount of remedial work arising out of one of the 2012 inspections, and to assess the effectiveness of any remedial action plans ESMA will require from CRAs as a result of the banking methodology work.

d) Risk analysis

17. During 2013 we intend to maintain and test the adequacy of our risk assessment framework created in 2012.

18. The analytical framework is composed of an impact assessment (defined as the potential damage caused to the market) based on a number of factors. These are risk-weighted and a total score attributed to each CRA. The score is then used to rank the CRA in one of the two impact categories identified to date. During 2013 we intend to refine our impact assessment so as to account for sectorial and geographical considerations.

19. The second pillar consists of the event probability (defined as the likelihood of regulatory failures) which is determined by supervisory judgements on a number of risk categories such as governance, business model or operational risk.

20. ESMA's risk analysis function is intended to capture and rank all major risks posed by registered CRAs. It achieves this through the analysis of multiple sources of information such as ratings and other reported data, market data, supervisory intelligence, and the conclusions that we draw from our on-going supervision. The risk analysis helps us to plan our supervisory activities in a risk-based manner.

e) Periodic reporting databases - CEREP and SOCRAT

21. ESMA currently operates two databases for the collection and analysis of periodic ratings data: a public Central Repository (CEREP) and a non-public Supervision of Credit Rating Agencies Tool (SOCRAT). In light of the CRA III amendments that require ESMA to develop and maintain a public ratings platform on its webpage, CEREP will be merged into the European Rating Platform. SOCRAT went live at the end of 2012 and is used for internal purposes to analyse data from periodic reporting by CRAs. During 2013, SOCRAT will be enhanced to incorporate risk analysis elements and contribute to the risk analysis framework. Links between SOCRAT and external market data will also be introduced to integrate specific market movements into its functionality.

f) Registration and enforcing the perimeter

22. ESMA's CRA supervisors are responsible for the registration and certification of new applicants. The assessment of compliance with the CRA Regulation at this stage provides us with important baseline information which is then used for the subsequent supervision of an entity once registered. A number of applications are currently in progress.

23. We expect that more firms will apply for registration in 2013, partly as a result of the work ESMA has carried out in 2012 into the identification of firms which we have assessed as operating within the scope of the CRA Regulation, but which, for a variety of reasons, have not applied for registered status. In 2013 we will issue industry guidance on the scope of the regulation, and will continue our perimeter work to ensure that all firms operating within the scope of the CRA Regulation are registered and there are no *free-riders*.

IV. 2013 policy activities

24. The implementation of the CRA III Regulation is of great importance for ESMA over 2013 and beyond, and, in particular, the ensuing work streams which have implications for supervision such as:

   a. the development of a rating platform;

   b. the fees charged by CRAs to their clients;

   c. the new transparency requirements for structured finance instruments;

   d. the prevention of conflicts of interest regarding CRAs' significant shareholders; and

   e. the new requirements for sovereign debt ratings.

25. Finally, in 2013 we will also respond to the European Commission (EC) request for ESMA's technical advice on the equivalence of the CRA rules in a number of third countries, initiate new endorsement tests and continue cooperating with our supervisory counterparts outside the EU, including through participation in IOSCO.