



European Securities and
Markets Authority

ESMA's supervision of credit rating agencies and trade repositories

2015 annual report and 2016 work plan



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List of Acronyms

ABS	Asset Backed Securities
CEREP database	Central Repository of credit rating data reported by CRAs to ESMA according to Commission Delegated Regulation 448/2012 of 21 March 2012 with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority
CEO	Chief Executive Officer
CLO	Collateralised Loan Obligation
CME TR	CME Trade Repository Ltd.
CRA	Credit Rating Agency
CRA Regulation	Regulation 1060/2009 on credit rating agencies as amended by Regulation 513/2011 of 11 May 2011 and Regulation 462/2013 of 21 May 2013
Delegated Regulation on Fees	Delegated Regulation 2015/1 of 30 September 2014 on the reporting of fees charged by credit rating agencies
DDRL	DTCC Derivatives Repository Ltd.
EMIR	Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)
EU	European Union
Fitch	Credit rating agencies within the Fitch group of companies
ICE TVEL	ICE Trade Vault Europe Ltd.
INED	Independent Non-Executive Director
IIO	Independent Investigating Officer
IRF	Independent Review Function



IT	Information Technology
IOSCO	International Organization of Securities Commissions
KDPW	Krajowy Depozyt Papierów Wartościowych S.A.
MiFID	Directive 2014/65/EU of 15 May 2014 on markets in financial instruments
MiFIR	Regulation 600/2014 of 15 May 2014 on markets in financial instruments
MoU	Memorandum of Understanding
Moody's	Credit rating agencies within Moody's Corporation
NCA	National Competent Authority
OTC	Over-the-counter
Q&A	Questions and answers
RADAR	ESMA's Credit Ratings Data Reporting tool
Regis TR	Regis TR S.A.
RRM	Registered Reporting Mechanism
REMIT	Regulation 1227/2011 of 25 October 2011 on wholesale energy market integrity and transparency
RL	Requested List Files
RBA	Reserve Bank of Australia
SFC	Securities and Futures Commission of Hong Kong
SFI	Structured Finance Instruments
SME	Small and Medium-sized Enterprises
S&P	Credit rating agencies within McGraw Hill Financial Inc.
Technical Advice	ESMA's Technical Advice on Competition, Choice and Conflicts of Interest in the CRA Industry of 30 September 2015
TR	Trade Repository
UnaVista	UnaVista Ltd
UTI	Unique Trade Identifier

1 Executive Summary

This annual report and work programme has been prepared pursuant to Article 21 of Regulation 1060/2009 on credit rating agencies as amended (the CRA Regulation) and Article 85 of Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR). It highlights the direct supervisory activities carried out by ESMA during 2015 regarding credit rating agencies (CRAs) and trade repositories (TRs) and outlines ESMA's main priorities in these areas for 2016.

ESMA adopts a risk-based approach to the supervision of CRAs and TRs in accordance with its overall objectives of promoting financial stability and orderly markets and enhancing investor protection. This risk-based approach requires the analysis of information from a variety of sources and the application of multiple supervisory tools including day-to-day supervision, cycle of engagement meetings with supervised entities, on-site inspections and dedicated investigations.

In order to build on the expertise that ESMA has developed through its supervision of CRAs and TRs, ESMA created a single Supervision Department in November 2015. ESMA intends to draw on the best practices identified from the supervision of both types of entity to further enhance its supervisory effectiveness in future.

CRA supervision

During 2015 ESMA assessed seven applications for registration in accordance with the CRA Regulation. Following these assessments, ESMA registered three new CRAs, bringing the total number of CRAs registered in the European Union (EU) to 26. In addition, four CRAs are certified by ESMA.

The risk assessment exercise conducted in 2014 identified that the areas of highest risk and greatest potential impact for CRAs related to CRAs' governance and strategy. For this reason, in 2015 ESMA focused on the supervision of CRAs' governance, risk management, internal decision making and business development processes.

ESMA's work on governance, risk management and internal decision making included examining the functioning of CRAs' boards and their deliberations and increasing its interaction with CRAs' Independent Non-Executive Directors (INEDs). This has helped to empower boards and embed INEDs' responsibilities for monitoring and oversight. As a part of its review of CRAs' internal decision making processes, ESMA concluded an investigation into the validation and review of CRAs' methodologies which resulted in the publication of a discussion paper in November 2015. ESMA also performed a risk assessment of the larger CRAs' IT and information security systems. This identified a number of risks of importance for all CRAs, which will inform ESMA's future work in this area.

In 2015 ESMA took enforcement action against one CRA in respect of a number of infringements of the requirements of the CRA Regulation regarding governance and compliance. These infringements, which were identified during a 2012 review of the CRA's compliance practices, resulted in the issuance of a public notice. The failing relating to the requirement to keep records also resulted in the imposition of a fine against a CRA for the first time. This case highlighted the need for CRAs to put in place effective compliance functions and to ensure that these are adequately resourced in order to promote a culture of compliance.

To improve its understanding of CRAs' business development processes, ESMA investigated the credit rating process and business development practices followed by a number of CRAs. ESMA also began examining CRAs' provision of ancillary and non-credit rating services and the fees charged for credit ratings and ancillary services. Through its work in this area, ESMA identified concerns regarding the use of support staff in the process of issuing credit ratings and reminded CRAs of the requirements of Article 7(4) of the CRA Regulation, that staff involved in the production of credit ratings must have appropriate skills and experience to carry out their duties. As regards the production of ancillary services, ESMA also raised concerns about the impact of providing ancillary services on CRAs' resources and highlighted the need for CRAs to implement processes to assess the potential conflicts of interest arising from the preparation of ancillary services and from analysts' interactions with clients of ancillary services.

In 2015, ESMA also focused its resources on further enhancing its risk-based approach to supervision. ESMA invested in developing the Ratings Data Reporting tool (RADAR) and the European Rating Platform and started developing specific tools to improve data centralisation and enhance its capacity for information analysis. In order to encourage uniform reporting by CRAs, ESMA published guidelines on the periodic information to be submitted by CRAs and Q&As on the application of the CRA Regulation as amended.

The risk assessment exercises carried out during the course of 2015 continued to identify high levels of governance and strategy risk in the CRA industry. These exercises also identified high levels of operational risk, which raises particular concerns for ESMA about the ability of CRAs to compete and to expand their businesses without this having a negative impact on the quality of the credit ratings they issue and the credit rating activities they conduct.

For these reasons, in addition to the assessment of applications for registration and its on-going investigations and enforcement work, the key areas ESMA will focus on in the supervision of CRAs in 2016 include CRAs' governance and strategy and the quality of CRAs' credit ratings and credit rating activities. In this context, ESMA will specifically examine the application of credit rating methodologies, the validation of models and methodologies, and IT issues specific to individual CRAs.

TR supervision

The supervision of TRs by ESMA started in 2013 with the registration of TRs in accordance with EMIR. ESMA had registered six TRs by November 2013, which triggered the trade reporting obligations to TRs set out in EMIR.

ESMA's supervisory work requires close cooperation with National Competent Authorities (NCAs) in the EU Member States as they are responsible for supervising the counterparties reporting to TRs which are the key users of TR data.

Trade reporting to TRs began in February 2014. By the end of 2015 almost 27 billion reports had been received by TRs, with an average of around 330 million trade reports submitted per week. ESMA has observed increasing interest in the TR business and is currently assessing two applications for registration. In addition, ESMA notes that registered TRs are looking to expand their businesses into new areas, for example by offering other reporting services.

The risk assessment exercise carried out in 2014 identified that the highest risks facing the TR industry related to their data and systems. Following the launch of trade reporting, it became clear that TRs needed to ensure that their systems could receive and process data efficiently, but also that the data received was of sufficient quality and could be made available to users in a timely and proper manner. For these reasons, ESMA's supervisory priorities for TRs during 2015 included the quality of the data submitted to TRs, access to data held by TRs and the operation and performance of TRs' systems.

During 2015, ESMA's supervision of data quality focused on the implementation of ESMA's data quality action plan, carrying out validation exercises to check on data quality as well as the supervision of inter-TR reconciliation and of the harmonisation and comparability of data made publicly available by TRs. Specifically on validation, ESMA progressed from data-completeness to data-content re-validation. These actions allowed ESMA to ensure that TR reporting increased the transparency of derivatives markets, which is one of the main objectives of EMIR. ESMA's work on access to TR data focused on enhancing and improving user access, including access by regulatory authorities which need TR data to support their supervisory responsibilities. ESMA also facilitated third country authorities' access to TR data by establishing Memoranda of Understanding.

As regards data quality and data access, ESMA carried out some specific supervisory activities regarding systems' operation and performance, including addressing incidents regarding data availability and accuracy, confidentiality and system availability, which were triggered by technical issues faced by TRs. Addressing those incidents required significant changes to some TRs' systems. ESMA has also started to consider TRs' resilience to potential cyber-attacks and effective business continuity during the course of 2015. The broad spectrum of ESMA's supervisory focus and ESMA's ability to monitor market developments and respond promptly to incidents is starting to show lasting improvements in each of these areas.

The risk-based assessment performed in 2015 was updated to identify the highest risks related to the operation of TRs and their compliance with EMIR. This exercise resulted in the identification of similar risks for 2016 as for 2015. However, the key risks have been further refined in this year's assessment so that the main priorities for TR supervision in 2016 will include data quality, data access and information security risks. During 2016 ESMA will also focus on financial risk for TRs, which will include TRs' costs and fee structures.

Areas of common supervisory focus

ESMA identified a number of supervisory areas in 2016 which are common to all supervised entities, such as their approaches to information security and the fees charged to customers.

ESMA will make use of all the supervisory tools at its disposal to achieve its objectives and will, in particular, seek to make increased use of investigations and to publish thematic reports to outline its views and clarify its expectations on issues of interest in appropriate cases. These thematic reports may be an effective means of encouraging the development of a culture of compliance within supervised entities, and may provide useful information of a general nature to market participants and other stakeholders.

2 Introduction

1. The European Securities and Markets Authority (ESMA) is one of the three European Supervisory Authorities (ESAs) which, together with the European Systemic Risk Board (ESRB) and National Competent Authorities, make up the European System of Financial Supervision (ESFS).
2. The ESFS was established in the wake of the global financial crisis with the aims of improving the quality and consistency of supervision, strengthening the oversight of cross-border groups and establishing a single rule book for all financial market participants within the European Union.
3. ESMA's mission is to enhance investor protection and promote stable and orderly financial markets. In 2011, ESMA was designated as the single supervisor of credit rating agencies (CRAs) within the EU in accordance with the provisions of Regulation 1060/2009 on credit rating agencies.¹ The following year, ESMA was given direct responsibility for the registration and the supervision of trade repositories (TRs) within the EU in accordance with Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories.²
4. In accordance with ESMA's strategic orientation for 2016-2020,³ ESMA is continuing to strengthen its role as a direct supervisor. As a part of this process, ESMA merged its supervision of CRAs and TRs into a new Supervision Department in 2015, which will allow it to build on existing expertise and ensure a consistent approach to direct supervision. The Supervision Department follows a risk-based approach and focuses its action in those areas where its resources may have the greatest impact.
5. This report provides an overview of the activities undertaken by ESMA in 2015 pursuant to the CRA Regulation and EMIR and sets out ESMA's supervision work plan for 2016.

¹ Regulation No 1060/2009 of 16 September 2009 on credit rating agencies, OJ L 302/1 of 17.11.2009 available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2009.302.01.0001.01.ENG&toc=OJ:L:2009:302:TOC, as amended by Regulation 513/2001 of 11 May 2011, OJ L145/30 of 31.5.2011 available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:145:0030:0056:EN:PDF>, and further amended by Regulation 462/2013 of 21 May 2013, OJ L146/1 of 31.5.2013, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0462&from=EN> (hereinafter the CRA Regulation).

² Regulation No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201/1 of 27.7.2012 available at: <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32012R0648> (hereinafter EMIR).

³ ESMA/2015/935, ESMA Strategic Orientation 2016-2020, 15 June 2015, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935_esma_strategic_orientation_2016-2020.pdf.

3 Supervision of Credit Rating Agencies

3.1 Credit Rating Agencies operating in the EU in 2015

6. The number of CRAs registered with ESMA increased to 26 in 2015, with the registration of three new CRAs.⁴ ESMA examined seven applications for registration in total, of which three applications were refused and one was withdrawn. The registration of three new CRAs in 2015 demonstrates that the markets for credit ratings in the EU are continuing to evolve and confirms the trend towards registration observed in the industry in recent years, following two registrations in 2014 and three registrations in 2013.
7. The CRA Regulation also provides that credit ratings issued by CRAs from third countries may be used in the EU where certain conditions are fulfilled.
8. Registered CRAs can endorse credit ratings issued outside the EU provided that the conditions set out in Article 4 of the CRA Regulation are met. This article provides that CRAs seeking to endorse credit ratings must be able to demonstrate to ESMA on an on-going basis that the conduct of the credit rating activities resulting in the issue of ratings to be endorsed fulfil requirements which are at least as stringent as those set by the CRA Regulation, subject to a number of exceptions.⁵ In 2015, five CRAs were endorsing credit ratings issued by third country CRAs for use in the EU: AM Best Europe - Rating Services Ltd, DBRS Ratings Ltd, as well as CRAs within the groups operated by Fitch, Moody's and Standard & Poor's (S&P).
9. CRAs established in third countries may also issue credit ratings on entities established or financial instruments issued in third countries which can be used for regulatory purposes in the EU where they have been certified as equivalent in accordance with the procedure set out in Article 5 of the CRA Regulation. There are currently four CRAs certified to issue credit ratings which can be used in the EU: Japan Credit Rating Agency Ltd, Kroll Bond Rating Agency, HR Ratings de México S.A. de C.V., and Egan Jones Ratings Co. No new applications for certification were received in 2015.
10. ESMA works closely with third country supervisors to monitor the operation of the endorsement and certification regimes and to consider issues of common interest with supervisors operating in different jurisdictions. In 2015 ESMA continued to participate actively in supervisory colleges organised at the international level and bilateral calls held to exchange views with fellow supervisors. ESMA finds the insights of third country supervisors helpful and will seek to enhance its supervisory effectiveness through further collaboration in this area in future. ESMA also wishes to highlight the positive engagement with certified CRAs which has taken place in 2015 and notes that it has

⁴ The groups of the three largest CRAs operating globally consist of 17 separate entities, so the total number of CRAs registered with ESMA is now 40.

⁵ Endorsed ratings do not need to comply with a number of the requirements of the provisions of Article 6a, 6b, 8a, 8b, 8c, 11a and Annex I Section B point 3 (ba), point 3a and 3b of the CRA Regulation.

benefited greatly from their contributions, for example to ESMA’s Call for Evidence on Competition, Choice and Conflicts of Interest in the CRA Industry.⁶

3.1.1 Industry data

11. The number of solicited and unsolicited credit ratings issued by asset class for each registered CRA provides an approximation of the overall size of the markets for rated entities and instruments for each asset class in the EU. The total number of long-term outstanding ratings for EU entities and instruments for each category of credit ratings is provided for 2013, 2014 and the first half of 2015 in the summary table below.

Table 1: Total number of outstanding credit ratings in the EU by category

Category of credit rating	2013	2014	First half 2015
Corporate financial	1,239	1,283	1,277
Corporate insurance	556	519	495
Corporate non-financial	33,195	32,844	28,098
Sovereign	893	896	904
Structured Finance Instruments	13,140	12,580	12,173
Covered bonds	14,290	13,729	13,236
Total outstanding	63,313	61,851	56,183

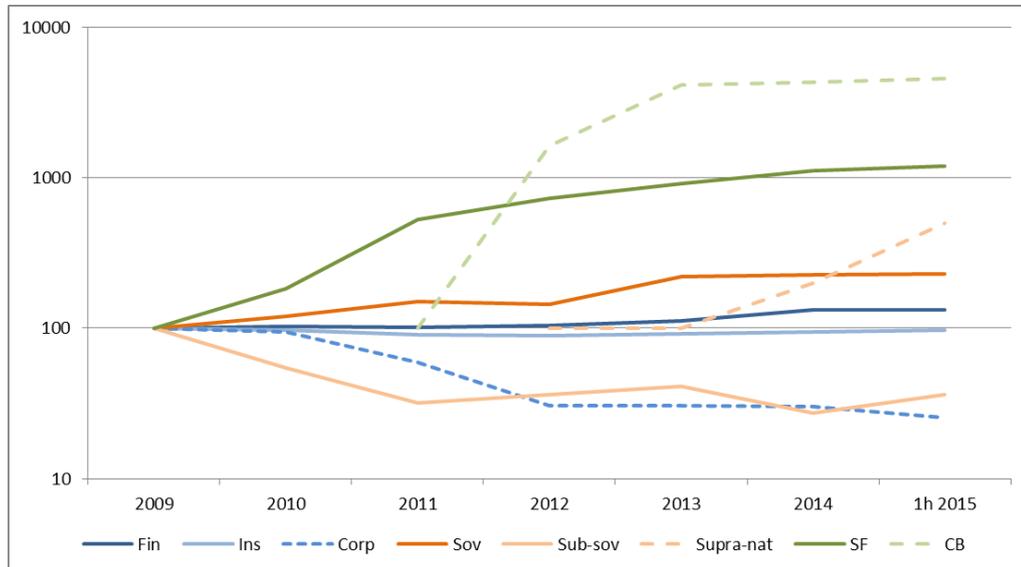
Source: CEREP, ESMA

12. ESMA notes that the information provided in the table is not homogeneous across asset classes as the numbers of rated structured finance instruments (SFIs) and covered bonds reported are the number of credit ratings at issuance level, whereas for the other categories the number reported represents the number of credit ratings at issuer level. This means that the data presented does not include credit ratings on individual corporate issuances so only one rating per entity is reported for corporate financial, non-financial and insurance entities as well as for sovereigns, regardless of the number of individual debt instruments issued by those issuers. This reflects the way that information is reported to ESMA’s CEREP database. This reporting practice means that the impact of credit ratings issued in respect of large corporations is likely to be understated as the total number of outstanding ratings for each corporation is not reported.

⁶ ESMA2015/233 Call for Evidence on Competition, Choice and Conflicts of Interest in the CRA Industry, 3 February 2015, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma2015-233_call_for_evidence_competition_choice_and_conflicts_of_interests_in_the_cra_industry.pdf.

13. Figure 1 below shows the evolution of outstanding credit ratings from all but the three largest CRAs operating globally.

Figure 1: Evolution of outstanding ratings – All CRAs excluding S&P, Moody's and Fitch (2009=100)*



Source: CEREP, ESMA

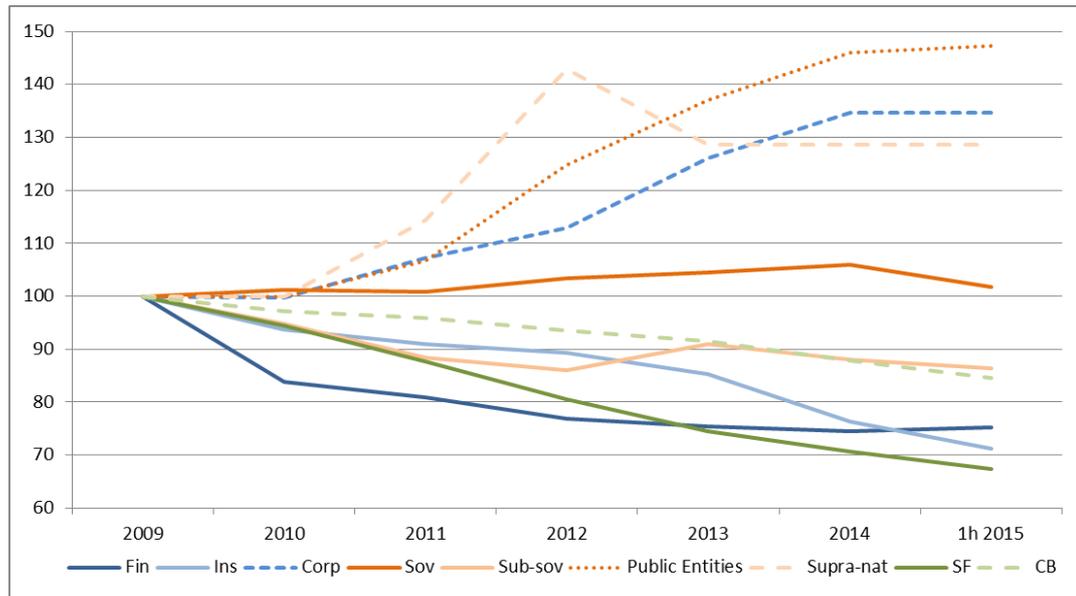
* The chart displays the percentage variation in outstanding ratings for each year compared to the base year (2009) on a logarithmic scale

14. Figure 1 shows that the outstanding credit ratings on SFIs from these CRAs increased by more than 10 times between 2009 (61 ratings) and the first half of 2015 (730 ratings). The issuance of covered bond credit ratings has also increased since the first year of reporting, moving from five ratings in 2011 to 229 ratings in the first half of 2015. Overall, the figure suggests that issuers and investors gradually began to look for alternative CRAs to rate their SFIs as the EU started to emerge from the 2008 financial crisis.

15. The chart also indicates that the number of corporate non-financial ratings from CRAs other than the three largest operating globally decreased considerably between 2010 and 2012. However, the figures for this specific asset class mainly reflect the decrease in ratings of Italian SMEs provided by one CRA, Cerved Rating Agency S.p.A. during this period.

16. Figure 2 below shows the evolution of the credit ratings of the three largest CRAs operating globally. The figure shows a substantial decrease in the number of outstanding credit ratings on SFIs. As regards corporate credit ratings, the number of financial and insurance entities rated also decreased, whilst the number of outstanding credit ratings on corporate non-financial entities increased substantially.

Figure 2: Evolution of outstanding ratings – S&P, Moody’s and Fitch (2009=100)*



Source: CEREP, ESMA

* The chart displays the percentage variation in outstanding ratings for each year compared to the base year (2009)

3.2 Key risks and priorities identified for 2015

17. In its 2014 Annual Report on the Supervision of CRAs and TRs, ESMA explained that, in 2015 it would seek to further enhance its risk-based approach to supervision. ESMA also explained that on the basis of an analysis of the key issues faced by the industry, the focus of its ongoing supervision would be to further improve its understanding of how the following influence the process of issuing credit ratings:

- CRAs’ governance, risk management and internal decision making processes.
- CRAs’ business development processes.

18. The following subsections explain how ESMA has enhanced its risk-based approach to supervision through the launch of a number of monitoring and strategy initiatives, and provide an overview of the work carried out in each of the priority areas identified by ESMA.

3.3 Monitoring and reporting

19. In 2015 ESMA focused on the uniformity of the information being reported by CRAs and on creating new frameworks for the internal monitoring and assessment of this information. ESMA also prioritised the establishment of its Credit Ratings Data Reporting system (RADAR) for the collection of data from CRAs.

3.3.1 Consistency of information reported

20. ESMA recognises that CRAs are not currently providing uniform reports, for example transparency reports, reports to the CEREPE database and the reports of revenues from credit ratings and ancillary services. There may be a number of reasons for this, including the broad definitions used in the CRA Regulation. This was recognised by ESMA in its Technical Advice to the European Commission on Competition, Choice and Conflicts of Interest in the CRA Industry,⁷ which noted the importance of ensuring consistency of reporting in facilitating effective supervision of CRAs. ESMA particularly highlighted concerns about inconsistent interpretations of the notion of ‘*ancillary services*’ and the impact that these could have on the amount of supervisory fees payable by CRAs and the market share calculations prepared for the purposes of Article 8d of the CRA Regulation.
21. In order to encourage uniform reporting, in 2015 ESMA published guidelines on some of the periodic reporting requirements in the CRA Regulation which apply to registered CRAs. This includes quarterly information about CRAs’ costs and revenues, staffing levels and internal complaints. It also includes semi-annual information about CRAs’ structure and governance, including work plans for the compliance, internal audit and risk management functions and details of any disputes or potential cases of non-compliance with the CRA Regulation.⁸
22. ESMA also responded to queries raised by CRAs about the approach to reporting solicited and unsolicited credit ratings through the CEREPE database. In December 2015 ESMA issued an update to its Q&A on the implementation of Regulation 462/2013 on credit rating agencies on this issue.⁹ The Q&A highlights that a solicited credit rating is issued following a request from the rated entity, issuer or the related third party.¹⁰

3.3.2 RADAR

23. In 2015 ESMA started implementing RADAR, the IT system needed to establish the European Rating Platform required by Article 11(a) of the CRA Regulation. RADAR will also be used by CRAs to comply with their obligations to report information to ESMA on their pricing practices and the fees charged for credit ratings and ancillary services required by Commission Delegated Regulation 2015/1 on the reporting of fees charged by Credit Rating Agencies (the Delegated Regulation on Fees).¹¹

⁷ ESMA/2015/1472 Technical Advice on Competition, Choice and Conflicts of Interest in the CRA Industry, 30 September 2015, available at: https://www.esma.europa.eu/sites/default/files/library/esma-2015-1472_technical_advice_on_competition_choice_and_conflicts_of_int.pdf.

⁸ ESMA/2015/609 Guidelines on periodic information to be submitted to ESMA by Credit Rating Agencies, 23 June 2015, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609.pdf>.

⁹ ESMA/2015/1877 Q&A on Regulation 462/2013, 16 December 2015 available at: https://www.esma.europa.eu/sites/default/files/library/esma-2015-1877_qa_on_the_implementation_of_the_regulation_eu_no_463_2013_on_cra.pdf.

¹⁰ as defined by Article 3(1)(i) of the CRA Regulation.

¹¹ Commission Delegated Regulation 2015/1 of 30 September 2014 with regard to regulatory technical standards for the periodic reporting of fees charged by credit rating agencies, OJ L2/1 of 6.1.2015 available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL_2015_002_R_0001.

24. RADAR has been built on a modern technology platform with enhanced data validation. The system is expected to improve the consistency of information reported, adding significant value to ESMA's supervision and monitoring activities and providing reliable data on credit ratings to market participants through the European Rating Platform.
25. In order to assist with the implementation of the new system, ESMA organised two training courses at its offices in May and December 2015. This training allowed ESMA to present the modules of RADAR to be used by CRAs to upload information about their credit rating activities and information about the fees charged for credit ratings and ancillary services.
26. CRAs will start testing the interface between their IT systems and RADAR during the first quarter of 2016 and are due to start reporting data on their credit ratings, pricing practices and fees to RADAR on 31 March 2016. ESMA will then start publishing the individual credit ratings submitted to it on the European Rating Platform in July 2016.

3.3.3 Data centralisation and information assessment

27. During 2015, ESMA has also worked to improve its internal systems in order to allow it to process information received from CRAs more effectively and to automate the production of information and statistics regarding the CRA industry.
28. ESMA is creating a dedicated tool to enhance its risk assessment activities. As the information and reports from CRAs become more standardised, this tool will facilitate the centralised storage of information received from CRAs and the use of this information in ESMA's supervisory risk dashboards. The creation of RADAR will contribute to the further enhancement of these systems. As ESMA's work in this area is still ongoing, further details can be found in the supervisory work plan below.
29. In addition, ESMA has developed an internal process for assessing notifications of new methodologies as well as changes to existing methodologies received from CRAs pursuant to Articles 8(5a) and 14(3) of the CRA Regulation. This process will allow ESMA to carry out a more robust assessment of CRAs' methodologies in future.

3.4 Governance, risk management, internal control and internal decision making processes

30. On 30 September 2015 ESMA provided Technical Advice to the European Commission about the functioning of certain aspects of the CRA Regulation. This included an assessment of the extent to which the CRA Regulation had helped to mitigate conflicts of interest in the CRA industry. ESMA considered its experience of CRAs' governance, risk management and internal decision making processes in order to make this assessment and highlighted a number of areas where the provisions of the CRA Regulation, in particular Articles 6-8 of the Regulation regarding conflicts of interest and the related
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requirements of Annex I, had helped to improve the functioning of the industry as a whole.

31. ESMA also identified a number of concerns regarding CRAs' internal control mechanisms and found that there was scope for further progress to be made in key areas such as the role of Independent Non-Executive Directors (INEDs). These findings are reflected in the ongoing supervision carried out by ESMA during 2015 as well as in the applications for registration considered. Indeed, some of the main reasons for refusing applications for registration in 2015 related to deficiencies in proposed governance, inadequate internal control systems, weaknesses in the development and validation of methodologies, the use of models and key rating assumptions.

3.4.1 Governance

32. In its Technical Advice, ESMA reported that in general terms, the CRA Regulation has helped to improve CRAs' corporate governance arrangements, inter alia, by requiring all CRAs to put in place an administrative or supervisory board.

33. The use of EU boards has helped to increase accountability for action taken and has had a positive impact on CRAs' decision-making processes and the documentation of decisions made. This has enabled ESMA to increase its understanding of the decision-making process followed in different CRAs, for example through the board minutes it receives.¹²

34. The introduction of boards within EU CRAs has also helped to ensure greater responsibility for compliance with the CRA Regulation at EU level. This has proved to be particularly beneficial for CRAs which operate as part of larger groups consisting of diverse businesses, or for CRAs with parent companies established in third countries, as it seeks to ensure that the governance of the EU CRA, as well as compliance with the requirements of the EU Regulation, remain a priority for the group as a whole. In this respect, ESMA encourages global CRAs to empower their EU Boards by improving the flow of information to and from their ultimate parent companies.

35. Many of the 38 notifications of changes to CRAs' initial conditions of registration ESMA received in 2015 related to changes in CRAs' structure, staff changes at senior management and board level or governance changes required by the opening of new offices. ESMA has been encouraging CRAs to empower their boards both when considering and implementing such changes. In particular, ESMA encourages close cooperation between a CRA's board members and key members of the internal control functions in advance of making key decisions. This allows the latter to consider and advise on how such decisions can be implemented in compliance with the CRA Regulation and on the implications of these decisions for the business within the EU, for

¹² ESMA/2015/609 Guidelines on periodic information to be submitted to ESMA by Credit Rating Agencies, 23 June 2015, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609.pdf>.

example in terms of the impact on effective monitoring and oversight or resourcing of key functions.

36. Whilst the CRA Regulation does not mandate the use of any one governance structure, it does require, through Annex I Section A point 4, that the CRA must *‘implement and maintain decision-making procedures and organisational structures which clearly and in a documented manner specify reporting lines and allocate functions and responsibilities’*. This was one of the requirements highlighted by ESMA’s 2015 enforcement case against DBRS Ratings Ltd. ESMA considered the CRA’s governance arrangements as a part of this case. It found that the CRA’s board of directors, which was ultimately responsible for the management of the company’s business, had been working alongside another body. These working arrangements failed to meet the requirements of the CRA Regulation as they had been implemented without putting in place delegation arrangements and reporting procedures.¹³

3.4.1.1 Independent Non-Executive Directors (INEDs)

37. The CRA Regulation requires that at least one third, but no less than two, of the members of a CRA’s supervisory board must be independent members.¹⁴ Independent Non-Executive Directors (INEDs) have special responsibilities under the CRA Regulation which requires them to monitor and provide opinions to the CRA’s board on the development of credit rating policy and methodologies, the CRA’s compliance and governance process, to ensure the effectiveness of CRAs’ internal control functions and policies and procedures regarding conflicts of interest.

38. CRAs with fewer than 50 employees can apply for an exemption from the requirement that at least one third of the members of the supervisory board are independent in accordance with Article 6(2) of the CRA Regulation. However, ESMA notes that in 2015 three CRAs benefiting from this exemption took steps to appoint INEDs. ESMA fully supports this approach and encourages all CRAs to appoint INEDs where possible as they play a key role, both on the board and in the overall governance of CRAs.

39. INEDs play a valuable role in the management of CRAs and provide a different perspective on CRAs’ internal control functions. ESMA seeks to build relationships with INEDs through its ongoing supervision to help empower them and encourage them to take a proactive approach to their oversight role by challenging the views and proposals of executive directors on the board as well as decisions taken by the board. For example, ESMA has found involving INEDs in monitoring the implementation of key remedial actions following an investigation by ESMA increases INEDs’ oversight of CRAs’ decision making processes.

40. ESMA interviewed a number of CRAs’ potential INEDs in 2015 to ensure that they have a detailed understanding of the CRA Regulation and their role and responsibilities under

¹³ ESMA/2015/1048, Public notice regarding compliance, corporate governance and record-keeping breaches by DBRS Ratings Limited, 24 June 2015, available at <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1048.pdf>.

¹⁴ Annex I Section A point 2 of the CRA Regulation as amended.

the CRA Regulation as well as sufficient expertise in financial services. In addition, ESMA also conducts interviews with resigning INEDs to gain further insights into the practical challenges of the role. A number of good practices have been identified through this process, including the induction training for INEDs being offered by some CRAs. ESMA would like to encourage all CRAs to provide this kind of training to INEDs to help them understand the spirit and the objectives of the CRA Regulation, the strategy and corporate governance structure of the CRA. This training is most valuable where it helps INEDs to appreciate the importance of safeguarding their independence from the commercial or business interests of the CRA and its board.

41. In its Technical Advice, ESMA also highlighted that it would like to play a greater role in the appointment of INEDs going forward to help ensure their effectiveness. For example ESMA believes that it can help CRAs and INEDs by setting out its expectations of the minimum standards of knowledge, independence and good repute INEDs need in order to be able to carry out the monitoring and reporting tasks required of them by the CRA Regulation.
42. As a part of this process, in November 2015 ESMA organised a roundtable for INEDs which gave them the opportunity to discuss their duties under the CRA Regulation and the challenges and best practices they have encountered. The roundtable provided a valuable forum for discussion. It also helped ESMA to clarify what it expects from INEDs and to further consider how it can support INEDs in future.
43. In 2014, ESMA sent a letter to INEDs highlighting their key tasks and responsibilities. Following the November 2015 roundtable, ESMA will send a further letter to INEDs regarding their accountability, their role in contributing to the establishment of a culture of integrity, compliance and ethics their respective CRAs as well as the establishment of a well-functioning internal control framework. The letter will also be sent to CRAs' CEOs in order to ensure that key decision-makers within the CRA facilitate the practical implementation of ESMA's expectations regarding INEDs.

3.4.2 Risk management

44. Annex I Section A point 4 of the CRA Regulation requires CRAs to put in place '*effective procedures for risk assessment*' but leaves each CRA free to choose how they comply with this requirement. ESMA has found that a number of the applications for registration it has received do not include a clear vision of how to implement risk assessment procedures and their place within CRAs' internal control structures.
45. In 2015 ESMA has sought to better understand CRAs' use of risk management processes. ESMA has achieved this through its ongoing supervision and through a number of investigations, including the information technology (IT) risk assessment investigation referred to in Section 3.4.3 below. ESMA has also held productive discussions with a number of CRAs during the course of 2015 regarding changes to their risk management processes.

46. ESMA finds that different approaches to risk management may be equally effective and that the approach that works best for each CRA will depend on its size and whether the CRA represents the company's sole interest or forms part of a group of diversified businesses. However, it is clear that there is a need to plan structural and organisational changes carefully so that their risk implications can be considered fully and that they can be implemented in compliance with the CRA Regulation.

3.4.3 Information technology and information security risk

47. One of the biggest risks currently faced by a number of CRAs relates to their IT systems. In order to meet the requirements of the CRA Regulation regarding the confidentiality, integrity and availability of the credit rating process, CRAs need to establish adequate and effective IT and information security internal controls.

48. ESMA has been monitoring CRAs' use of IT systems and in 2015 it launched a risk assessment exercise to improve its understanding of the risks associated with the IT systems and processes used by the three largest CRAs operating globally.

49. ESMA identified a number of common IT risks faced, which are of importance for all CRAs operating in the EU:

- Governance and strategy.
- Information security.
- Internal audit and enterprise risk management.
- IT systems development and project management.
- Operations.

50. ESMA will draw on the results of its risk assessment exercise in developing its future supervision work in this area, further details of which are provided in the Supervision work plan for 2016 set out in Section 5.3.2 below.

3.4.4 Compliance

51. ESMA has continued to examine the work of CRAs' compliance functions throughout 2015. ESMA believes that an independent compliance function is one of the cornerstones of the CRA Regulation. ESMA has been seeking to ensure that the importance of this function is recognised by CRAs through both its enforcement work and its supervisory action.

52. In June 2015, ESMA concluded an enforcement case which highlighted the need for CRAs to put in place effective compliance functions and to ensure that these are adequately resourced in order to promote a culture of compliance within their organisations. ESMA issued a public notice in respect of a number of internal control failings identified within DBRS Ratings Ltd in 2012, including failing to ensure that conditions were in place to enable the compliance function to discharge its

responsibilities properly. The failing related to the requirement to keep records resulted in a fine.¹⁵ With regard to the compliance function, one of ESMA's concerns was that the CRA did not have a formal work plan and its compliance records were incomplete. ESMA found that the requirements of Annex I Section A point 6(a) of the CRA Regulation had not been met in this case, as the compliance function did not appear to have the necessary authority, resources, expertise and access to all relevant information to discharge its duties. ESMA welcomed the steps taken by DBRS Ratings Ltd to remediate the infringements of the CRA Regulation voluntarily and recognised such steps by reducing the amount of the fine imposed.

53. This case demonstrates some of the challenges regularly faced by CRAs' compliance officers. ESMA organises roundtable events to help compliance officers to consider these challenges and best practices for resolving issues encountered. The fourth annual roundtable event for compliance officers took place at ESMA's offices in Paris in November 2015. The roundtable gave CRAs' compliance professionals a forum for discussion and reflection on how to ensure meaningful compliance with the provisions of the CRA Regulation regarding their risk assessment, monitoring, reporting and advisory roles. The round table will be followed by a letter to compliance officers that will further highlight ESMA's expectations of CRAs' compliance functions and ESMA will continue to maintain an open dialogue with CRAs to help understand their compliance related decisions going forward.
54. The key message arising from the roundtable was the need for the compliance function to be active at all levels of the CRA. In practice this means encouraging CEOs and their senior management teams to accept responsibility for promoting a culture of compliance. This ensures the correct tone from the top as well as ensuring that the compliance function is visible to and meaningful for all staff. How best to achieve this will depend on the specific needs and compliance risks faced by each CRA. However, it is clear that CRAs need to take steps to ensure that their compliance functions are being properly resourced in order to achieve this. In this regard, ESMA notes that in 2015, a number of CRAs hired additional staff into their compliance functions.

3.4.5 Internal review function and validation and review of methodologies

55. ESMA has considered the role and responsibilities of the Independent Review Function (IRF) through a number of different pieces of work carried out in 2015, from the assessment of applications for registration, to its investigations into the credit rating process and the assessment of CRAs' validation and review processes.
56. Through its assessment of applications for registration, ESMA found that there was some confusion regarding the work of the IRF, particularly regarding the boundaries of its role in relation to credit rating activities. The CRA Regulation requires CRAs to establish a review function which is responsible for *'periodically reviewing its methodologies, models*

¹⁵ ESMA/2015/1048, Decision of the Board of Supervisors of 24 June 2015, referred to in footnote 10 above.

and key rating assumptions'.¹⁶ It further states that *'the review function shall be independent of the business lines which are responsible for credit rating activities'* and shall *'report to the members of the administrative or supervisory board*'.¹⁷

57. The CRA Regulation contains a number of broad requirements with respect to the review of methodologies that CRAs use to prepare credit ratings. Article 8(3) of the CRA Regulation requires CRAs to use credit rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing. ESMA does not interfere with the content of CRAs' methodologies, but is required to examine CRAs' compliance with Article 8(3) of the CRA Regulation. Each CRA is also required to review its credit ratings and methodologies on an ongoing basis, or at least annually, in accordance with Article 8(5) of the CRA Regulation.¹⁸

58. In 2015, ESMA performed an investigation into the validation and review of methodologies performed by larger CRAs. ESMA found that there were significant variations in the validation techniques applied, as well as in the processes and procedures in place and the governance arrangements being used by CRAs to ensure validation. ESMA found that CRAs could enhance the validation techniques that they use, especially in cases where there is little quantitative evidence available, for example for a new asset class or where limited data is available, such as for asset classes with low default rates.

59. In November 2015, ESMA issued a discussion paper on the validation and review of credit rating agencies' methodologies in order to present its findings and highlight good practices identified during its investigation and on-going supervision.¹⁹ Feedback on this discussion paper will help ESMA develop its general views on the quantitative and qualitative techniques that could be used as part of the validation of methodologies required under the CRA Regulation. This will help ESMA to ensure that appropriate and proportionate standards for these quantitative and qualitative techniques are being used throughout the CRA industry.

3.4.5.1 Monitoring and review of structured finance instruments

60. ESMA's investigation into the validation and review of methodologies drew on a number of the findings of ESMA's 2014 investigation into credit ratings on SFIs.²⁰ This investigation raised concerns that CRAs' processes and practices for monitoring and reviewing credit ratings on SFIs were not consistent and were not always sufficiently robust. Furthermore, ESMA highlighted that these processes did not ensure the

¹⁶ Annex I Section A point 9 (1).

¹⁷ Annex I Section A point 9 (2).

¹⁸ Further insights into the processes to be followed to ensure credit ratings and methodologies are rigorous, systematic, continuous and subject to validation can be found in Commission Delegated Regulation 447/2012 of 21 March 2012 laying down regulatory technical standards for the assessment of compliance of credit rating methodologies, OJ L 140/14 of 30.5.2012 available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32012R0447>.

¹⁹ ESMA/2015/1735, Discussion Paper on the validation and review of Credit Rating Agencies' methodologies, 17 November 2015, available at: https://www.esma.europa.eu/system/files_force/library/2015-1735_discussion_paper_on_validation_final.pdf.

²⁰ ESMA/2014/1524, ESMA's investigation into structured finance ratings, 16 December 2014, available at: https://www.esma.europa.eu/system/files_force/library/2015/11/esma-2014-1524_cra_public_report_on_sf_u_investigation.pdf.

independence of the review function. Following this investigation, CRAs implemented remedial action plans in 2015 which included a number of changes to the role of the IRF, not just in respect of credit ratings for SFIs, but for all asset classes.

61. In 2015 a number of CRAs made improvements to their internal processes for identifying and escalating errors in the application of methodologies to the IRF and for ensuring that all the key factors identified in their published methodologies are taken into account during annual reviews of credit ratings. As part of this review, CRAs should now consistently analyse loan level data and revisit their cash flow models. CRAs' reviews should also identify and assess the counterparty, operational and legal risk associated with the pools of assets underlying SFIs. A number of CRAs have also taken steps to improve their record keeping, to demonstrate how the annual reviews of methodologies by the IRF have been carried out and to help ensure appropriate follow up.
62. To ensure the independence of the IRF, some CRAs took steps in 2015 to make sure that analysts involved in the credit rating process are not involved in review activities and do not vote in committees approving or validating the models to be used in the credit rating process. ESMA notes that some CRAs have now established specialist committees to manage changes in methodologies, in order to ensure that all credit ratings which may be affected have been identified and to manage the process of consultation and review required by Articles 8(5a) and 8(6) of the CRA Regulation where new methodologies or material changes to existing methodologies are proposed.²¹

3.4.6 Credit rating process

63. In 2015, ESMA also concluded an investigation into the process of issuing credit ratings by one CRA. During its investigation, ESMA identified concerns about the process of issuing credit ratings, the process of changing methodologies and the involvement of the CRA's internal control functions. ESMA also identified concerns regarding the use of support staff in the credit rating process and the provision of ancillary services which are set out in more detail in Sections 3.5.2 and 3.5.3 below.
64. A number of ESMA's findings concerning the process of issuing credit ratings related to the way in which CRAs assign credit ratings to a company's individual debt issues once they have provided a credit rating in respect of the company. These credit ratings are known as issue ratings. ESMA raised concerns regarding the process of deriving these credit ratings from the rating of the underlying entity, which was in some cases found to be too mechanical or to lack sufficient analytical input.
65. CRAs must ensure that issue ratings are prepared by credit rating analysts following a thorough review of all the issue documentation. In particular, CRAs must ensure that they

²¹ In 2014, ESMA issued an update to its Q&A on the CRA Regulation regarding the meaning of material changes to methodologies, models or key credit rating assumptions. See ESMA/2014/578, 2 June 2014, Q&A on the implementation of the CRA Regulation. The most recent update to the Q&A, ESMA/2015/1877 of 16 December 2015, is available at https://www.esma.europa.eu/system/files_force/library/esma-2015-1877_qa_on_the_implementation_of_the_regulation_eu_no_463_2013_on_cra.pdf.

have all of the information necessary to assign a credit rating to an issue. Analysts must be able to assess all aspects of a transaction before they provide an issue rating, including any structural subordination arrangements and guarantee clauses and must take into account clauses which may not support the issuer or programme rating. CRAs must record the findings of this review in order to allow for systematic oversight of decisions made and ensure that the credit rating issued is based on sound analysis.

66. ESMA is currently monitoring the implementation of the actions taken by the CRA in question and is considering carrying out follow up work with other CRAs in respect of issue ratings in 2016.

3.5 Credit Rating Agencies' business development processes

67. The second area of the CRA industry that ESMA identified in its 2015-2016 work plan was the impact that CRAs' business development processes have on the process of issuing credit ratings. This is a wide ranging concept which covers the way in which CRAs develop and sell their products and services. It includes:

- the independence of the credit rating process from the commercial interests of the business;
- the skills and responsibilities of staff involved in business development and the preparation of CRAs' products and services;
- the level of fees charged for credit ratings and ancillary services; and
- the scope of services which can be provided by CRAs.

68. In 2015, ESMA has increased its understanding of these issues through its work on conflicts of interest, fees and ancillary services. It also oversaw a number of changes in CRAs' behaviour through the implementation of remedial action plans arising from its investigations into the process of issuing structured finance instruments and corporate credit ratings.

3.5.1 Shareholders

69. Article 6(1) of the CRA Regulation requires CRAs to take all necessary steps to ensure that the process of issuing credit ratings is not affected by any existing or potential conflicts of interest or business relationships involving the CRA and related companies as well as its shareholders, managers and employees. The CRA Regulation also includes specific requirements in Annex I Sections A, B and C which are designed to ensure that potential conflicts of interest do not unduly influence the credit ratings issued by CRAs.

70. The independence of the process of issuing credit ratings is an important part of the assessment of applications for registration received by ESMA. ESMA considers the composition of the various boards and committees within CRAs in order to ensure that they will not give rise to conflicts of interest or that any conflicts arising can be adequately managed within the framework of the CRA Regulation.

71. Through this work, ESMA has identified a number of concerns regarding the potential involvement of shareholders and business leaders in the process of preparing and issuing credit ratings. For example, in 2015 one application for registration included a proposal that the CEO of the applicant's parent company could chair the CRA's rating committee. Although the CEO had significant skills and experience which would have allowed him to make an effective contribution to the credit rating process, ESMA could not reconcile this with the requirement of Annex I Section A point 2 of the CRA Regulation which requires the CRA to be *'organised in a way that ensures that its business interest does not impair the independence or accuracy of the credit rating activities'* unless the CEO gave up his position in the parent company and divested the interest he held in that company.
72. The 2013 amendments to the CRA Regulation included a number of additional provisions specifically aimed at ensuring that CRAs' independence could not be compromised by links between a CRA, its shareholders, related companies and other CRAs. Article 6a of the CRA Regulation prevents those with an investment of 5% or more in the capital of a CRA or holding 5% or more of the voting rights from holding more than minimal interests in other CRAs, unless they are part of the same group of CRAs. With respect to investments and other interests in rated entities, Annex I Section B point 3a requires a CRA to disclose whether any of its existing credit ratings are potentially affected by these kinds of investments or interests. Furthermore, Annex I Section B point 3 prevents a CRA from issuing new credit ratings on entities in certain cases where an entity or related third party has an investment or interest of 10% or more in the capital or voting rights of the CRA, is a member of the board or is otherwise able to exercise significant influence on the business activities of the CRA.
73. Article 4(3)(b) of the CRA Regulation notes that these requirements do not apply to endorsed credit ratings. However, Article 4(4) makes it clear that CRAs should not use endorsed ratings as a way to circumvent compliance with these provisions, or indeed any provisions of the CRA Regulation.
74. In 2015, ESMA investigated CRAs' ownership structures to identify cross shareholdings in multiple CRAs, and the shareholdings of CRAs and their board members in rated entities and related third parties, to monitor compliance with these requirements of the CRA Regulation. ESMA identified a number of cross-shareholdings in CRAs through this exercise and is questioning the CRAs involved in order to ensure that these shareholdings are compliant with Article 6a of the CRA Regulation.
75. ESMA is also assessing whether CRAs have adequate procedures and internal control mechanisms in place to ensure that they do not issue credit ratings or rating outlooks on entities in which they or their parent companies have invested and that a CRA discloses cases where any of its existing credit ratings or rating outlooks may be affected by its shareholdings or those of its members and shareholders. ESMA will continue its work in this area in 2016.

3.5.2 Ancillary services

76. Annex I Section B, point 4 of the CRA Regulation states that CRAs may provide services other than the issue of credit ratings. The Regulation refers to these services as ancillary services and explains that they *'comprise market forecasts, estimates of economic trends, pricing analysis and other general data analysis as well as related distribution services'*.
77. A CRA may offer any of these services to its clients as long as doing so does not present conflicts of interest with its credit rating activities and the provision of these services is disclosed in the CRA's final credit rating reports. However, Annex I Section B point 4 of the CRA Regulation contains an important exception to this, which prohibits CRAs, and those in a position to exercise significant influence over the business activities of the CRA, from providing consultancy or advisory services to rated entities or related third parties in relation to their corporate or legal structure, assets, liabilities or their activities.
78. In 2015 ESMA considered the provision of ancillary services by CRAs through its investigations and its ongoing supervision as well as through its participation in the International Organization of Securities Commissions' Committee 6, which is examining the creation and sale of products other than credit ratings by CRAs and related companies.
79. In its recent investigation into the credit rating process followed by one CRA referred to in Section 3.4.6 above, ESMA identified a number of concerns regarding the provision of ancillary and non-rating services. These related to the implementation of processes for the assessment of potential conflicts of interest in the preparation of ancillary services and the oversight of analysts' interactions with clients using these services as well as the impact of providing ancillary services on the CRA's analytical resources.
80. Through its ongoing supervision, ESMA has found that CRAs have different ideas as to which of the services they provide should be classed as credit rating services and ancillary services. Indeed, in its Technical Advice to the European Commission, ESMA expressed concerns that CRAs are not adopting a consistent approach to the definition of ancillary services. ESMA understands that CRAs have different organisational structures and that some CRAs may provide ancillary services through separate companies. ESMA has noted the requests received from a number of CRAs to provide guidance on the scope of the definition provided in the CRA Regulation in this regard. Further details of ESMA's future work in this area are provided in the supervision work plan below.

3.5.3 Staffing

81. The CRA Regulation recognises that a CRA employs different types of staff in different areas of its business and establishes a framework to ensure that the structure and functioning of the CRA does not impair the independence or accuracy of the credit rating activities. In particular, Article 7(1) of the CRA Regulation requires staff involved in the

production of credit ratings to have appropriate skills and experience to carry out their duties.

82. During its investigation into the credit rating process followed by one CRA, ESMA examined the use of support staff in the credit rating process. The CRA Regulation does not prevent CRAs from using support staff in the rating process, for example to carry out data entry tasks and to provide administrative support or assistance. Whilst only qualified analysts should carry out analytical work, ESMA understands that there may be situations where support work could have an impact on the preparation or issue of credit ratings and ancillary services, for example where support staff are involved in document management or review or in providing contributions to background reports.
83. In order to ensure effective compliance with the CRA Regulation, the responsibilities of support staff should be clearly defined and communicated to all staff. This is important for the support staff themselves in knowing what kind of work is expected of them in different roles but also for the managers and for the analytical staff who delegate tasks to them.
84. These findings apply equally to outsourced staff. ESMA notes however, that there are a number of additional risks and requirements associated with outsourcing, for example regarding confidentiality of information, quality control and ESMA's ability to supervise a CRA's compliance with the CRA Regulation. Therefore, CRAs should be mindful of these issues when using this type of business model.
85. Any incidental analytical tasks carried out by support staff must be overseen by analytical staff to ensure that the work meets the required levels of accuracy. CRAs must make sure that sufficient analytical resources are available in order to allow analysts to perform this oversight role without detracting from their own analytical work.
86. ESMA also raised concerns about the adequacy of resources used in the credit rating process in its 2014 investigation into structured finance instruments. In order to comply with remedial action plans issued by ESMA following this investigation, several CRAs introduced new resource management tools in 2015 to monitor and report on the adequacy of the resources used in their analytical activities.

3.5.4 Fees charged for credit ratings and ancillary services

87. The CRA Regulation contains a number of provisions designed to ensure that commercial considerations do not impair the independence or accuracy of credit rating activities. Article 7(2) of the CRA Regulation requires CRAs to ensure that staff involved in the negotiation of fees are not involved in the process of producing credit ratings and Annex I Section B 3c requires CRAs to ensure that fees charged for the provision of credit ratings and ancillary services are not discriminatory and are based on actual costs. This provision states that *'fees charged for credit rating services shall not depend on the level of the credit rating issued by the CRA or on any other result or outcome of the work performed'*.

88. In order to supervise the fees charged by CRAs, the 2013 amendments to the CRA Regulation required ESMA to provide draft regulatory technical standards for reporting. These were adopted and entered into force in January 2015 as the Delegated Regulation on Fees.²² In February 2015 registered CRAs submitted their first reports to ESMA under the Delegated Regulation on Fees. These reports provided copies of CRAs' pricing policies and procedures as well as details of their fee programmes and fee schedules for credit ratings and ancillary services.
89. The pricing documents submitted generally reflect CRAs' understanding of Section 7(2) of the CRA Regulation which requires CRAs to ensure that rating analysts, employees and other persons involved in the issuing of credit ratings do not initiate or participate in negotiations regarding fees or payments with any rated entity.²³ For the most part, CRAs' pricing documents allocate this responsibility to dedicated business development or client relationship managers or to the CEO.
90. The number of pricing documents reported and the level of detail they contained differed quite significantly between CRAs. This in part reflects the different sizes and business models of the CRAs registered in the EU. In general terms, the pricing documents show that CRAs price different types of credit ratings and ancillary services differently and that the level of fees charged by CRAs may differ where CRAs offer credit ratings in a number of different geographic areas. In addition, it is clear from the documents submitted that a number of CRAs have introduced specific provisions into their pricing policies or have adapted their pre-existing pricing documents to comply with the Delegated Regulation on Fees and the requirement of Annex I, Section B 3c of the CRA Regulation.
91. The reporting of fees charged for individual credit ratings and ancillary services is due to begin in 2016 once the testing of ESMA's RADAR Fees Reporting Module has been carried out with CRAs. However, in 2015 ESMA considered fees charged by CRAs for credit ratings and ancillary services in its 2015 Technical Advice to the European Commission. ESMA noted that more than half of the issuers and a number of the users of credit ratings who responded to ESMA's Call for Evidence on Competition, Choice and Conflicts of Interests in the CRA Industry reported that they had faced frequent fee increases for the credit ratings and related data products they purchased from the largest CRAs operating globally. ESMA will continue to consider fees charged by CRAs in its future work in this area, which is described in more detail in the supervision work programme set out in Section 5 below.

²² Commission Delegated Regulation 2015/1 of 30 September 2014 with regard to regulatory technical standards for the periodic reporting of fees charged by credit rating agencies, OJ L2/1 of 6.1.2015 available at: <http://eurlex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:32015R0001&from=EN>, last accessed 26.08.2015.

²³ and related third party or any person directly or indirectly linked to the rated entity by control.

4 Supervision of Trade Repositories

4.1 Trade Repositories operating in the EU

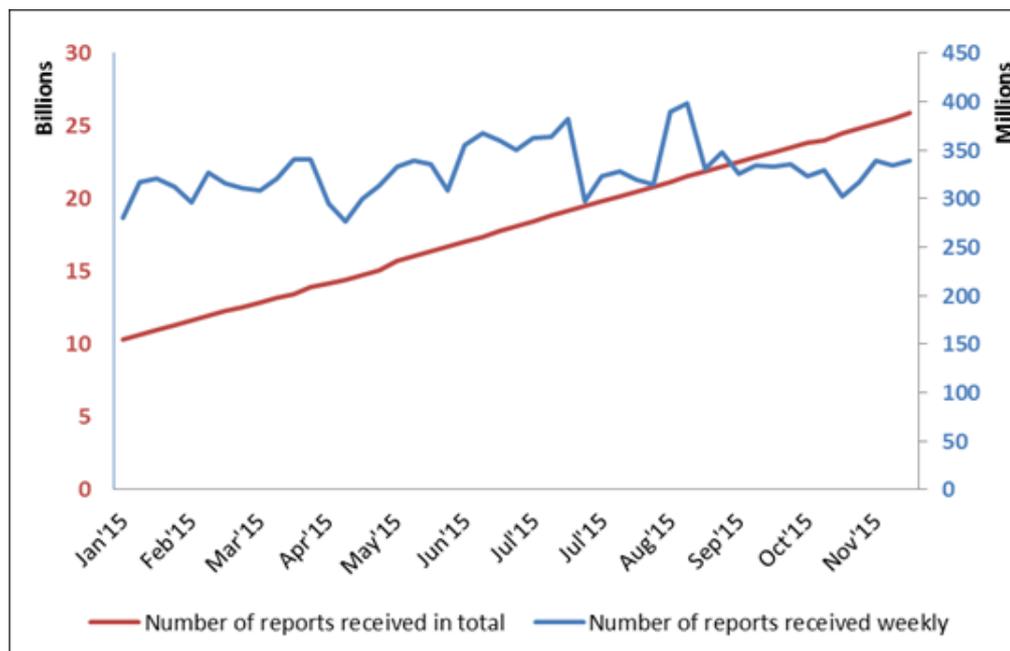
92. Trade reporting was established in the EU with the entry into force of EMIR. It plays a central role in enhancing the transparency of derivatives markets and reducing risks to financial stability.
93. Since 12 February 2014, counterparties have been required to report details of their exchange traded or over-the-counter derivative contracts to a registered TR or a TR recognised under EMIR. There are currently six TRs registered in the EU which have been operating since 2013. DTCC Derivatives Repository Ltd (DDRL), UnaVista Ltd, ICE Trade Vault Europe Ltd (ICE TVEL) and CME Trade Repository Ltd (CME TR) are all established in the UK; Regis TR S.A. (Regis TR) which is established in Luxembourg; and Krajowy Depozyt Papierów Wartościowych S.A. (KDPW) which is established in Poland.
94. ESMA is currently examining two further applications for registration. In addition, the services being offered by TRs are also starting to evolve, which suggests that the dynamics of the markets for trade reporting are changing.
95. Since their registration in 2013, five of the six TRs have been offering trade reporting services for all five asset classes of derivatives trades reported under EMIR: commodity derivatives, credit derivatives, equity derivatives, interest rate derivatives and foreign exchange derivatives. One TR was offering trade reporting services for all these asset classes except foreign exchange until June 2015, when it was registered for this asset class by ESMA following an application to offer these services. Consequently, all registered TRs are currently able to provide reporting services for all the aforementioned asset classes.
96. Some TRs have also started expanding their commercial offerings to provide reporting services in other areas such as those required by Regulation 1227/2011 of 25 October 2011 on wholesale energy market integrity and transparency (REMIT). More specifically, in 2015 ESMA received notifications from ICE TVEL, CME ETR and Regis TR that they were applying to be registered as a Registered Reporting Mechanism (RRM) with the Agency for the Cooperation of Energy Regulators in order to offer trade reporting services under REMIT.
97. ESMA asked each of these TRs to demonstrate that they could continue to comply with the requirements of EMIR once registered as RRM by showing that:
- REMIT services would be operationally separated from the EMIR services in terms of systems, procedures and resources;
 - the TR had adequate resources to cope with the increase in activities;
 - potential conflicts of interests would be properly managed;

- fees for the services under EMIR would not be bundled with fees for services under REMIT; and
- customers would be able to access the services under EMIR or REMIT without an obligation to use the other type of service.

98. It is possible that some TRs may become Approved Reporting Mechanisms for the purposes of the Markets in Financial Instruments Directive and Regulation²⁴ (MiFID II/MiFIR) in the future and may extend their registration as TRs²⁵ in order to receive reports of securities financing transactions. Other TRs may establish joint ventures with such providers in the future in order to offer packages of complementary reporting solutions to clients.

99. By the end of 2015 the six TRs operating in the EU had collected nearly 27 billion reports in total. Article 80(3) of EMIR requires TRs to retain these reports for at least 10 years following the termination of the relevant contracts. 2015 was also the first full year of reporting the complete set of 85 fields required by EMIR. During the course of this year, the level of reporting activity has stabilised at an average of around 330 million submissions per week, as illustrated in figure 3 below.

Figure 3: Evolution of trade reporting in 2015



Source: Weekly statistics provided to ESMA by TRs

²⁴ See Directive 2014/65/EU on markets in financial instruments, OJ L 173 of 12.6.2014 available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0349.01.ENG (MiFID 2) and Regulation No 600/2014 on markets in financial instruments, OJ L 173 of 12.6.2014, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0600> (MiFIR).

²⁵ Under Regulation 2015/2365 of the European Parliament and the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation No 648/2012, OJ L 337 of 23.12.2015, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32015R2365>.

100. ESMA monitors the status of reporting activity for each TR regularly, by reviewing a number of different sources of information including weekly statistics received from TRs, ad hoc data sample checks and the aggregated data published on TRs' websites as required by Article 81(1) EMIR and Article 1 of Commission Delegated Regulation 151/2013.²⁶
101. To ensure that TRs comply with the requirements of EMIR and to assess the key risks arising in the industry, ESMA also reviews the periodic information submitted by TRs such as annual reports, interim financial statements, compliance reports and audit reports. For example, in 2015 ESMA received 38 notifications from TRs related to material changes to the initial conditions of their registration. These notifications mainly covered changes to TRs' key staff or board members, changes in fee structure and pricing policies and the launch of new services including ancillary services.
102. These notifications have been assessed for compliance with EMIR requirements. In particular, ESMA has assessed whether or not changes to key staff would result in the TR not having adequate human resources, as required by Article 78(4) of EMIR. In addition, following changes to a TR's pricing policy ESMA has assessed whether their fees are in line with the requirements of providing non-discriminatory access to TRs and charging fees which are related to the costs of providing TR services, as set out in Articles 78(7) and (8) of EMIR. In relation to notifications of an intention to launch a new service, ESMA has assessed whether the TR can ensure it is dedicating sufficient resources to EMIR reporting and whether or not the additional activities pose a risk to the core TR services that the TR must provide in accordance with Articles 78-81 of EMIR.
103. Finally, while lower than in previous years, ESMA continued to receive a number of complaints about potential failures of TRs to fulfil their obligations under EMIR. In 2015, the complaints received mainly related to operational IT problems and pricing practices, whereas in the past they typically related to on-boarding and data access.

4.2 Key risks and priorities identified for 2015

104. In 2015, ESMA's supervision of TRs focused on the key areas identified through the risk-based assessment and the specific actions set out in the work programme for 2015. The main risks identified related to:
 - data quality;
 - access to data; and
 - the operation and performance of systems.

²⁶ Commission Delegated Regulation 151/2013 of 19 December 2012 supplementing Regulation 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, with regard to regulatory technical standards specifying the data to be published and made available by trade repositories and operational standards for aggregating, comparing and accessing the data, OJ L 52/33 of 23.02.2013 available at: <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ%3AL%3A2013%3A052%3ATOC>

105. These horizontal issues were investigated through thematic reviews and were complemented by two on-site inspections which considered confidentiality, access to data and data integrity. In addition, ESMA carried out a number of monitoring activities related to incident reports, information and complaints received and notifications of changes to the initial conditions of TRs' registrations.
106. ESMA continued to work closely with the National Competent Authorities (NCAs) responsible for supervising the counterparties reporting to TRs. The NCAs have provided valuable information to ESMA in carrying out its supervisory activities. ESMA also benefited from international cooperation and participated in a number of international work groups and fora where it shared its experience on TR matters. In particular, ESMA participated in the Peer Review established by the Financial Stability Board on Reporting of OTC Derivatives to Trade Repositories, in the relevant work-streams of the Committee on Payments and Market Infrastructures (CPMI), in the IOSCO Committee regarding the harmonisation of derivatives reporting as well as in the OTC Derivatives Regulators' Forum work on data quality.

4.3 Data quality

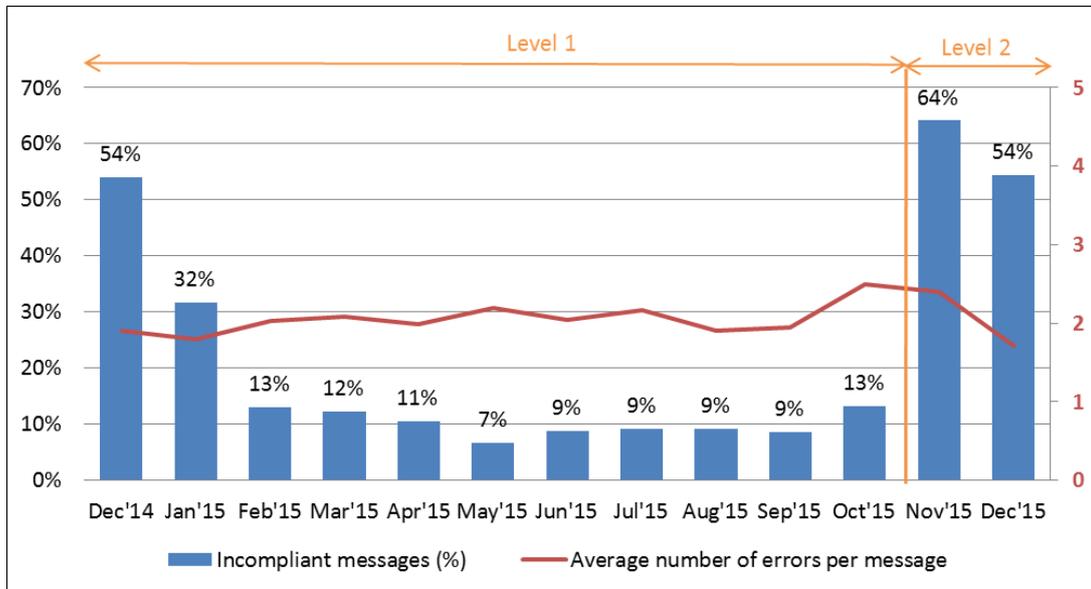
107. Data quality is a high priority for ESMA's supervision of the TRs. Given the dual supervisory framework of EMIR, where ESMA supervises TRs and NCAs supervise the entities which report to them, a joint effort is necessary to ensure good quality data. To this end, ESMA and NCAs established a Data Quality Action Plan in September 2014 which defined the actions to be undertaken by each side. The following paragraphs summarise the key actions taken by ESMA with respect to data quality.

4.3.1 Actions taken to monitor harmonised validation implementation and re-validate harmonised data

108. The implementation of validation rules as defined by ESMA and the NCAs in the form of a Q&A is an important step towards improving TR data quality. In order to ensure a smooth implementation of the rules the project was scheduled into two phases. The first phase, known as the Level 1 validations, was put in place in December 2014. This aimed to ensure that the data reported was complete to the extent possible. The second phase, known as the Level 2 validations, started in November 2015. These seek to ensure that the data reported is accurate.
109. During the implementation phase of these validations, ESMA had a number of individual and group interactions with TRs through meetings and conference calls in order to review the validation specifications they had prepared and to address their comments and questions on the validation rules.
110. After implementation of the Level 1 validation rules in December 2014 (completeness validations) as well as the Level 2 validation rules in November 2015 (content validations), ESMA has regularly performed a re-validation of the data made available to it. In order to assess whether the validation requirements have been implemented

correctly by the TRs, ESMA randomly selects one day for which the complete daily activity reports across all TRs are re-validated. When necessary, ESMA has followed up with the TRs to make sure amendments are implemented. The graph below presents the results of the re-validation performed during the year 2015.

Figure 4: Rates of re-validation non-compliant messages across all TRs



Source: ESMA calculations based on daily activity reports from all TRs

111. In the period immediately after the Level 1 validation was implemented in December 2014, the data made available to ESMA was to a large extent non-compliant with the validation requirements. By informing the TRs which fields contained erroneous values and by explaining that the validation rules were necessary, ESMA's supervision activities led to further improvements in this area. The monitoring of data quality through re-validation is an ongoing activity and has again intensified with the implementation of the Level 2 validation rules in November 2015. This is reflected in the increase in the number of non-compliant messages in the graph above.

4.3.2 Actions taken with regard to inter-Trade Repository reconciliation

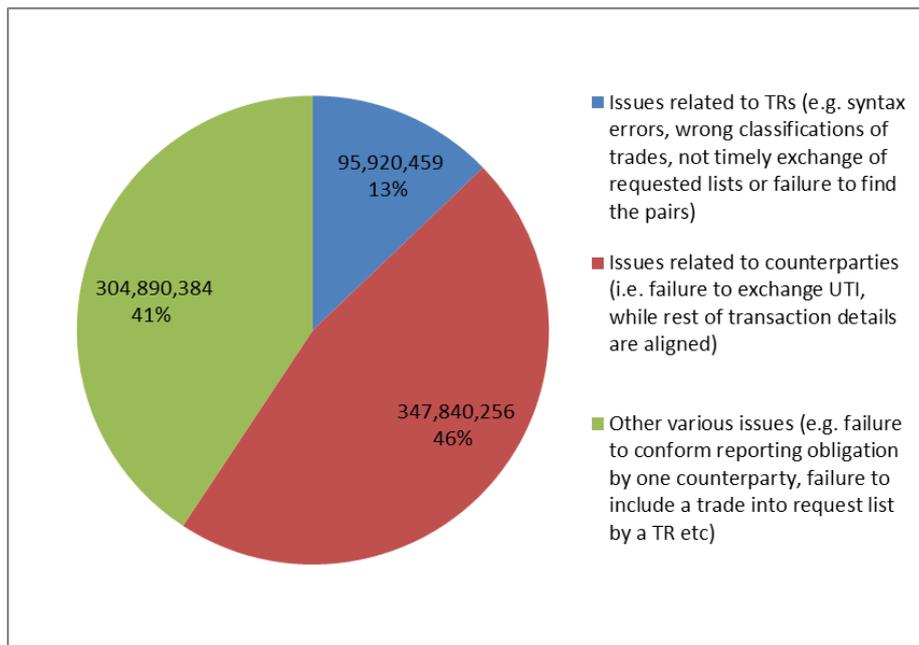
112. ESMA conducted an extensive review of the inter-TR reconciliation process in 2015 and asked TRs (i) to provide ESMA with the Requested List (RL) files that they were exchanging during the first stage of the inter-TR reconciliation process (pairing of counterparties IDs and Unique Trade Identifiers (UTI)); (ii) to perform an internal analysis of their implementation of the inter-TR reconciliation process in order to identify and report to ESMA the corresponding deviations; and (iii) to provide ESMA with their specifications for preparing the reconciliation statistics.

113. ESMA has performed an independent review and analysis of the RL files by setting-up and running a simulation exercise of the pairing phase of the Inter-TR reconciliation process in order to identify potential format, content or other reasons for failings in the inter-TR pairing process. In the next step, the TRs' internal assessment of the process

was cross-checked against ESMA’s findings. This allowed ESMA to identify a comprehensive list of issues and actions required by TRs to address those issues.

114. In particular, this exercise has shown that there is a large number of trades that are not reconciled because of unshared UTI values between the counterparties. This potentially accounts for up to 50% of the all unreconciled trades. The following graphic shows the results of ESMA’s exercise.

Figure 5: Reasons for failure of inter-TR reconciliation identified through Requested List analysis



Source: ESMA calculations based on analysis request lists received from all TRs

115. The results of the analysis were shared with TRs and discussed during a roundtable held on 27 October 2015. A remedial action plan has been put in place and is currently being implemented by TRs. This plan includes actions relating to the format and content of the files exchanged and actions for improving the process itself.

116. Moreover, ESMA has designed a Reconciliation Status Report which shows for each pair of counterparties the reconciliation status of all their trades from the beginning of reporting, classifying them in different categories: single-sided unpaired; single-sided paired; single-sided matched; dual-sided paired; dual-sided matched; not submitted to reconciliation and non-EEA. This report allows ESMA and the NCAs to monitor the reconciliation process from their different perspectives in a consistent manner.

4.3.3 Actions taken with regard to harmonised public data

117. Article 81(1) of EMIR and Article 1 of Commission Delegated Regulation 151/2013 require TRs to publish aggregate information regarding the data reported to the TR on a website or online portal at least once a week. TRs must publish a breakdown of the

aggregate open positions per derivative class, a breakdown of aggregate transaction volumes per derivative class and a breakdown of aggregate values per derivative class.

118. All TRs started publishing aggregate data from February 2014. The overall aggregation of publicly available data across TRs was initially presented in non-comparable formats, due to different levels of data granularity, frequency of publication, and the different presentation structure and formats chosen by TRs. From April 2015 onwards, public data has been available in a more harmonised format and updated weekly by all TRs. The information available includes: open positions, volume of trades and values broken down by derivative class, type, trade type (single-sided EEA, single-sided non EEA, or dual-sided²⁷). This enables users to aggregate and compare data across TRs. It also allows market participants to monitor dynamics and trends in derivatives trading in the EU, including identifying what has been traded on and off-venue.
119. ESMA is monitoring the evolution of public data on an ongoing basis. At an aggregate level, it contains certain values reported by counterparties that are clear outliers and might be erroneous. ESMA liaises with TRs where it identifies such values. However, TRs are not always able to address concerns which relate to values reported by counterparties as the TRs only publish the data as it is reported to them.

4.3.4 Actions taken with regard to Trade State files

120. This report is an important tool that provides supervisors with a snapshot view of all outstanding trades on a given day. With a view to ensuring the standardisation of trade state reports across TRs, ESMA clarified to TRs that the reports should be provided every day, should contain the latest version of all outstanding trades and should include at least all 85 mandatory fields labelled with their respective names in accordance with the EMIR technical standards.

4.3.5 Ongoing supervision of data quality

121. In 2015, ESMA developed a data quality dashboard as a tool for monitoring the quality of data. The dashboard is updated on a monthly basis and summarises statistics that indicate the level of data quality across different dimensions. The current dashboard contains graphics that support the monitoring of re-validations, rejections, public data, reconciliation information and other data characteristics; together this provides a global view on TR data quality. The tool will be complemented with additional statistics in the future to allow ESMA to better identify issues related to data quality.

²⁷ Dual-sided means that the TR has both sides of the trade; single-sided EEA (European Economic Area) means that the TR has one side of the trade and knows that the other side is EEA based; single-sided non EEA means that the TR has one side and knows that the other side does not have a reporting obligation, either because they are non-EEA or because they are an individual.

4.4 Access to data

122. A number of TRs have experienced delays in registering clients and providing them with access to the TR since EMIR reporting began in early 2014. However, these difficulties were largely resolved by the end of 2014. By the end of 2015 the TRs had around 6000 direct clients. This number includes some third parties who report on behalf of other counterparties and entities which have the right to view data that has been reported on their behalf only.
123. Some TRs were also delayed in providing competent authorities with access to the TR data stored in their databases in 2014. This was of concern to ESMA as one of the main objectives of EMIR is to provide competent authorities with information regarding derivatives trades to enable them to fulfil their oversight responsibilities. However, the difficulties encountered have now been resolved by the TRs in question and the number of authorities that are able to access TR data has gradually increased during 2015. Some NCAs are not yet using their right to access and use TR data, mainly because of the lack of resources needed to process and consolidate the data received from the different TRs operating. Throughout 2015, the TRs supervised by ESMA harmonised the format including for example, field names, and separators of output files in order to facilitate the use of TR data.
124. In order to further facilitate competent authorities' access to TRs' data, ESMA is currently developing an IT system which will allow NCAs to submit data queries through a centralised web portal. The system will distribute the queries to TRs and will receive files containing the transaction data required in response from each TR. NCAs will be able to download the responses to their queries through a single data transmission channel. The objective of the project is to provide NCAs with a single point of access to the data stored by TRs under EMIR legislation. When implemented, this project should assist regulatory authorities in using TR data more actively.
125. ESMA has monitored the progress on access to TRs by competent authorities throughout 2015. In November 2015, 38 regulatory authorities including NCAs and central banks had access to at least one TR.
126. A number of third country regulatory authorities are able to access TR data as their authorities have entered into a Memoranda of Understanding with ESMA in accordance with EMIR and the ESMA Regulation.
127. In this respect, a Memorandum of Understanding was established in February 2015 between ESMA and the Reserve Bank of Australia (RBA) for access by RBA to data on derivatives contracts held in European TRs which is relevant for its supervisory tasks.²⁸

²⁸ Following the MoU between ESMA and the Australian Securities and Investments Commission, an MoU has been established between ESMA and the Reserve Bank of Australia, available at: http://www.esma.europa.eu/system/files/mou_signed_rba_-_esma.pdf

128. In addition, in November 2015 ESMA concluded a Memorandum of Understanding with the Securities and Futures Commission (SFC) of Hong Kong for the exchange of information on TR data. This cooperation will allow each authority to have indirect access to the TR data it needs for its supervisory functions. A number of similar Memoranda of Understanding are currently being discussed with other third country authorities.
129. In 2015 ESMA conducted two on-site inspections to assess the procedures, practices and controls in place in relation to TRs' obligations under Article 81 of EMIR to make TR data available to regulators. In particular, the work focused on regulators' on-boarding process, access provision and filtering of the TR data according to their mandate. ESMA is still in the process of analysing all the information collected during these inspections and determining whether potential remediation actions are needed.
130. In December 2015, ESMA launched a consultation on operational standards for data access and aggregation and comparison of data across TRs. The proposed amendments to the current rules aim to enhance the direct and immediate access to data by authorities and to facilitate the aggregation and comparison of data across TRs. Following the assessment of the responses received, a final report will be prepared and submitted to the European Commission. Pursuant to Article 10 of Regulation 1095/2010 establishing a European Securities and Markets Authority (the ESMA Regulation),²⁹ the European Commission has three months from the receipt of a draft regulatory technical standard by ESMA to decide whether to endorse it.

4.5 Operation and performance of systems

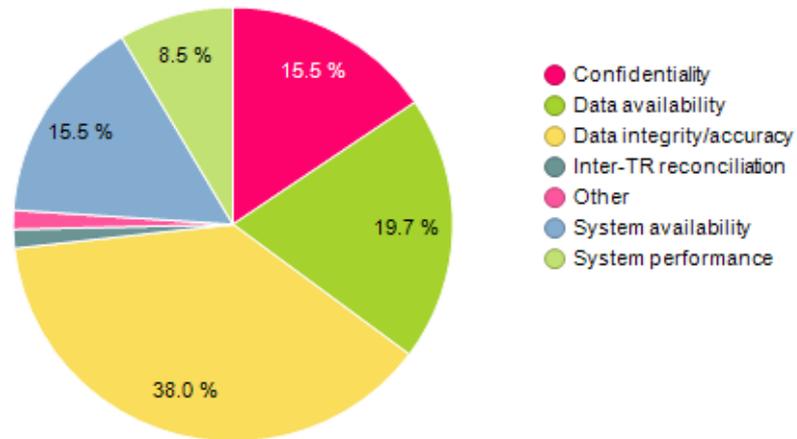
131. During the course of 2015, ESMA received several notifications from TRs regarding operational matters. TRs reported a number of incidents that resulted in the temporary unavailability of their systems or services or the inability of market participants or regulators to access TR data. TRs also reported instances where information had been disclosed to non-authorised parties and some cases where data integrity and accuracy had been affected. ESMA followed up on these reports where needed.
132. These incidents were frequently attributed to technical problems like software bugs, system and infrastructure configuration errors, hardware failures and administration errors. However, errors by reporting participants, operational errors or procedural omissions were also the cause of some incidents.

²⁹ OJ L 331/84 of 15.12.2010 available at: <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:0119:EN:PDF>.

133. The following graph presents aggregated statistics for all TRs per incident type.

Figure 6: TR incidents reported by type

Incidents per type



Source: ESMA incident notification log

4.5.1 Monitoring of Trade Repositories' systems, functionality and changes implemented

134. During 2015, ESMA monitored the operation of TRs' systems and the implementation of changes in general, as well as the system performance of one specific TR for which ESMA had identified concerns during 2014.

135. ESMA's supervisory initiatives in 2015 regarding for example, data validation and data quality, public data harmonisation and inter-TR reconciliation, have required some TRs to make considerable changes to their systems and develop their software.³⁰ ESMA has discussed and clarified the changes required with TRs and agreed relevant milestones and implementation deadlines. Furthermore, ESMA has followed up to ensure that changes were made without disturbing or disrupting the smooth operation of TRs' systems and services.

136. In 2015, NCAs alerted ESMA to a number of concerns regarding the reporting functionalities of certain TRs. In one case, an NCA notified ESMA that some TRs had not implemented a filter for data to regulators based on the ID of the counterpart, as set out in EMIR Q&A TR question 37, as updated in October 2014. As a result of this timely report, ESMA has been able to focus its attention on the measures taken by

³⁰ Such changes related to the implementation of requirements posed by Q&As TR Questions 37, 20 and the respective validation table, inter-TR reconciliation status report, individual fixes with regard to inconsistent implementation of validation rules.

TRs, assessing the complexities of the changes needed for the systems of the individual TRs and monitoring their implementation.

4.5.2 Trade Repositories' systems software development lifecycle

137. Within the context of ESMA's investigations, an individual review was performed for one TR with regard to its software development and system deployment procedures, its practices and the controls in place.

138. The review focused on the overall software development life cycle and in particular on the following areas:

- business case analysis and feasibility study;
- business, functional and non-functional requirements analysis and specification;
- IT solution selection and system design;
- design and technical implementation of the different processing environments;
- system and software development and implementation standards;
- software and system testing and quality assurance; and
- IT project management and change management processes.

139. The results of this review as well as the respective remediation actions are currently being finalised, following which the need for enforcement action will be assessed.

140. The two on-site inspections that took place in 2015 also included areas of systems operational reliability and data integrity with a focus on:

- the procedures and controls in place to acquire and deploy reliable and error-free system components and systems as a whole; and
- the controls in place to ensure the accuracy and integrity of data throughout the cycle of data input, processing, transfer and output.

141. ESMA is in the process of analysing the information collected during these inspections, determining whether potential remedial actions are necessary and assessing whether there are serious indications that any of the infringements set out in Annex I of EMIR may have occurred.

4.5.3 Cyber resilience and business continuity planning

142. Cyber-attacks are becoming one of the most significant risks that financial market infrastructures are facing in the current integrated and highly automated operational environment. TRs, as a crucial link in the transaction chain, may become targets of potential cyber-attackers aiming to achieve financial gain or competitive advantage or seeking to create market disruption and undermine financial stability.
143. The fact that TRs' systems are connected to the systems of numerous reporting entities holding trading data about a significant number of derivatives trades in their databases increases the inherent risk of them being targeted by an organised cyber-attack.
144. Given the direct systemic consequences that such an attack could have on the orderly functioning of financial markets, ESMA recognises the importance for TRs to have a strong and effective cyber-security capability. In the last quarter of 2015, ESMA launched a thematic review across the TR industry. The primary objectives of the review are to:
- understand TRs' perceptions of the current cyber security risk environment;
 - collect information about the current defence mechanisms and controls used by TRs to protect their data from cyber-attacks; and
 - collect and analyse information about TRs' ability to recover critical services in a timely manner in the event of an attack.
145. ESMA will continue this review in 2016 as set out in the Supervision work plan below.

5 Supervision work plan for 2016

5.1 Supervisory approach

146. Following the publication of ESMA's strategic orientation for 2016-2020, an internal reorganisation took place which merged ESMA's supervisory activities relating to CRAs and TRs into a dedicated Supervision Department. The new Supervision Department will build on the expertise ESMA has developed in each of these areas and improve its supervisory effectiveness by drawing on the best practices identified through the supervision of each type of entity.
147. ESMA uses a wide range of supervisory tools to achieve its objectives of promoting financial stability and orderly markets and enhancing investor protection: from discussions with supervised entities through its on-going supervision to thematic investigations. In addition, ESMA liaises with the competent authorities in the Member States to encourage supervisory convergence and cooperates with supervisors at international level regarding issues of common supervisory interest.
148. ESMA seeks to stimulate behavioural change through its supervisory activities as well as through a variety of communications, from the individual letters and remedial action plans it sends to supervised entities to industry-wide guidelines, Q&As and the publication of thematic reports and reports from its investigations. In 2016 ESMA will make greater use of thematic reports to set out its views on issues of importance to supervised entities as a whole.
149. Investigations are a helpful way of understanding and addressing particular issues affecting supervised entities in more detail. ESMA intends to make greater use of investigations on specific topics or into the practices of individual entities in 2016. ESMA may conduct on-site inspections to gather evidence during the course of its investigations which may involve interviewing members of staff, examining and collecting data samples and analysing entities' internal and external communications.
150. Enforcement action may be another effective way to change industry practices. In 2016 ESMA will devote further resources to its enforcement work and will appoint an Independent Investigating Officer (IIO) in accordance with the CRA Regulation and EMIR where it identifies indications of the possible existence of facts which may constitute a regulatory infringement.
151. There is close collaboration with the NCAs responsible for the supervision of the market participants using the services of the CRAs and TRs. ESMA benefits greatly from their insights, whether through bilateral contacts or through Technical and Standing Committees. ESMA will continue to encourage supervisory convergence in areas which have a significant impact on its work during 2016, such as the reporting practices of counterparties under EMIR and of issuers and related third parties under the CRA Regulation.

152. ESMA's supervisory effectiveness will be further enhanced in 2016 by increasing international cooperation with third country supervisors. This will be achieved by concluding Memoranda of Understanding and entering into working arrangements which will allow for the exchange of information relating to common supervisory issues and will facilitate joint investigations in appropriate cases.
153. In order to ensure that it targets its resources effectively, ESMA adopts a risk-based approach to supervision and prioritises the supervisory action that it will take each year in accordance with its objectives of promoting financial stability and orderly markets and enhancing investor protection.
154. These risk assessments are made by considering industry trends and the risks identified from market monitoring activities as well as information from notifications and periodic reports submitted by supervised entities. ESMA also gathers evidence from complaints and market intelligence received, through its cycle of engagement meetings with supervised entities and through the use of calls for evidence and requests for information. As a part of this process, ESMA assesses risks of non-compliance with both the letter and the spirit of the relevant regulations and prioritises action in areas where it may have the greatest impact. ESMA does not publish the details of the risk assessments it carries out in respect of supervised entities, but instead provides details of the key risks and challenges it has identified through the publication of its areas of supervisory focus in its work plan for the coming year.
155. Sections 5.2-5.5 below identify the market developments and key risks which will inform ESMA's approach to the supervision of CRAs and TRs for 2016, highlighting the common themes which have been identified at this stage. These areas of focus may change during the course of the year if higher priorities are revealed as a result of market or other developments,³¹ and are without prejudice to ESMA's day-to-day supervisory activities including market monitoring, the assessment of notifications received from supervised entities and complaints received from market participants, the assessment of applications for registration and the preparation of enforcement cases.

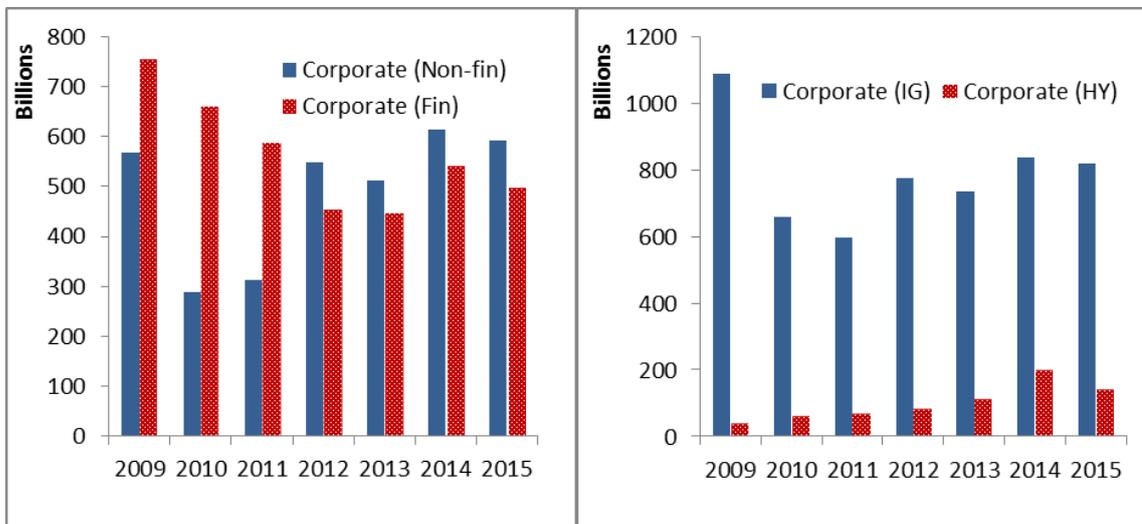
5.2 Credit Rating Agencies

156. This Section highlights some of the market conditions in which CRAs are currently operating, focusing on the most significant challenges and risks faced by CRAs during 2015. These are some of the risks and challenges which have determined the key areas for ESMA's supervisory focus in 2016.

5.2.1 Underlying market conditions

157. CRAs' businesses are heavily dependent on the issuance of fixed income instruments, which is in turn dependent on underlying financing conditions. Overall, European credit market conditions were relatively benign in 2015. As shown in Figure 7 below, the issuance of corporate bonds remained relatively stable when compared to 2014, with high volumes of corporate financial and non-financial bonds being issued. The majority of issued bonds were investment grade, with a slight decrease in the volume of non-investment grade corporate bonds issued in 2015 compared to 2014.

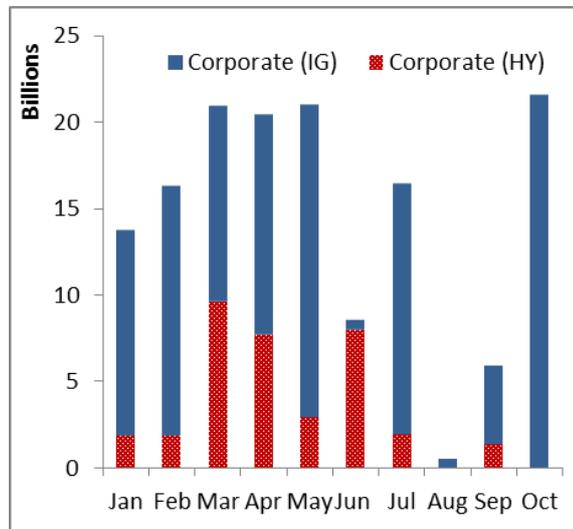
Figure 7: Financial and non-financial corporate bond issuance in the EU between 2009 and 2015 at investment (IG) and non-investment grade (HY)



Source: Dealogic. Note: EUR billion

158. The key factors which have impacted EU credit markets in 2015 were the potential default of Greece and the risk of contagion to other EU sovereigns, the slowdown in the Chinese economy and declining commodity prices. These events created a certain amount of price volatility in the EU markets. The effects of this volatility were reflected in a steep decline in the issue of high-yield corporate non-financial bonds in August 2015. However, Figure 8 below shows that issuance volumes increased again in the last half of 2015, which reflects the dynamism of this relatively niche fixed income asset class.

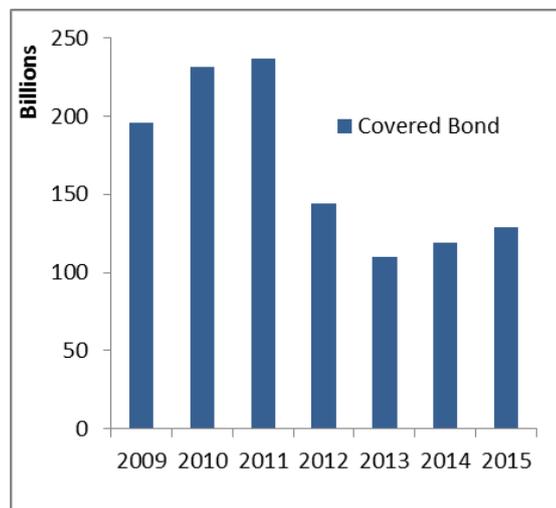
Figure 8: High yield and investment grade corporate bond issuance in the EU January-October 2015



Source: Dealogic. Note: EUR billion

159. Figure 9 below shows that there has been a moderate increase in covered bond issuance in 2015, which may be attributed in part to the European Central Bank's covered bond asset purchase programme and the favourable regulatory treatment of covered bonds in the EU under the Bank Recovery and Resolution Directive³² as well as to investors' hunt for yield.

Figure 9: Covered bond issuance in the EU



Source: Dealogic. Note: EUR billion

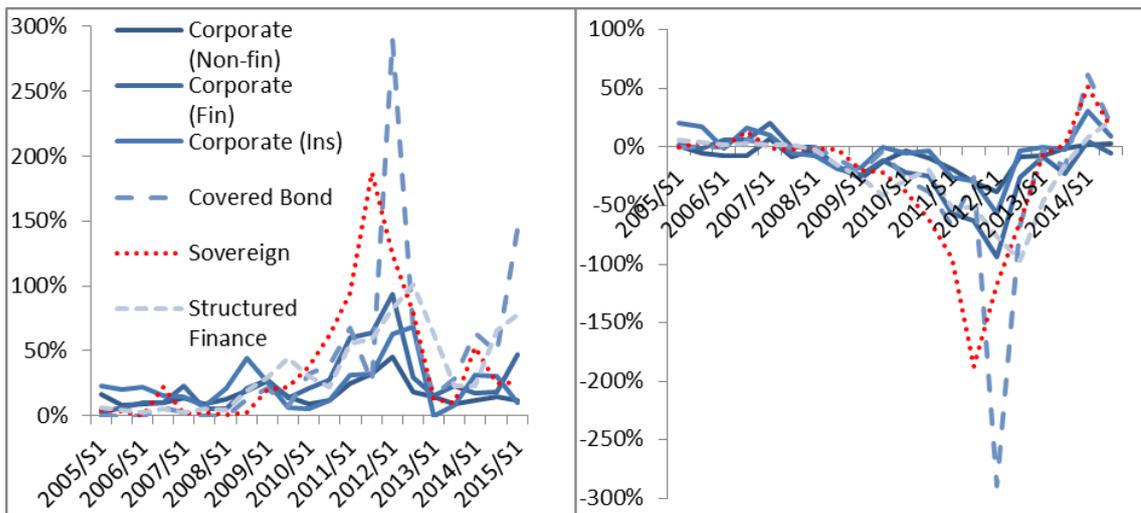
160. The markets for SFIs also showed signs of growth in 2015, although new issuance volumes remained low when compared to pre-crisis levels and the overall pool of

³² Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173/190, 12.6.2014 available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0059>.

outstanding securities continued to shrink as outstanding instruments reached maturity. Certain types of securitisation have experienced a revival, which may have been encouraged by the European Commission’s Action Plan for a Capital Markets Union³³ and the promotion of simple, safe and transparent securitisations.³⁴ There has been an increase in the issue of instruments focused on small and medium-sized enterprises (SMEs), such as Collateralised Loan Obligations (CLOs) and Asset Backed Securities (ABS), which is likely to continue in to 2016.

161. As the broader economic situation in Europe stabilises, changes to credit ratings in Europe have become fewer in number and neutral in terms of direction, meaning that the number of downgrades no longer outpaces the number of upgrades. This has particularly been the case for sovereign and corporate non-financial credit ratings. At the same time, changes to credit rating methodologies and upgrades in sovereign country ceilings have led to a large wave in upgrades for credit ratings on SFIs and covered bonds since late 2014, specifically in those EU Member States which were most exposed to the sovereign debt crisis.

Figure 10: Notch-weighted volatility and drift of credit ratings issued by the three largest credit rating agencies operating globally for Greece, Ireland, Italy, Portugal and Spain



Source: CEREP, ESMA

³³ Commission Communication, Action Plan on Building a Capital Markets Union, COM/2015/468 of 30.09.2015 available at: http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf.

³⁴ Proposal for a Regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation, COM/2015/0472 of 30.09.2015 available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015PC0472>

5.2.2 Competition between Credit Rating Agencies

162. The evolving credit market conditions are encouraging issuers to seek alternative sources of funding, for example through the use of covenant-lite loans and other innovative products. This may create new opportunities and challenges for CRAs looking to expand their businesses.
163. CRAs operate in two sided markets, competing to attract issuers, investors and subscribers to their platforms. This can be challenging as issuers are keen to use those CRAs which are recognised by the largest number of investors they wish to target and investors and subscribers want to use those CRAs which can offer the greatest coverage of the issuers and instruments they are interested in. CRAs compete to win business on a number of parameters including the quality of the products and services they offer and the fees that they charge.
164. Many of the issuers and users of credit ratings that responded to ESMA's Call for Evidence on Competition, Choice and Conflicts of Interest in the CRA Industry explained that they had not seen a lot of evidence of competition between CRAs. However, data reported by CRAs to the CEREP database shows that a number of CRAs are now starting to challenge the three largest CRAs in some areas. Smaller CRAs and new entrants are starting to make an impact in some national markets for corporate credit ratings and a minority are establishing a presence in the markets for structured finance and covered bond credit ratings in some Member States, as demonstrated by the share of supply charts presented in ESMA's Technical Advice.³⁵ The presence of these CRAs may increase further once the External Credit Assessment Institutions (ECAI) mapping exercises required by the Capital Requirements Directive³⁶ and Solvency II³⁷ have been completed.
165. Some respondents to ESMA's Call for Evidence noted that CRAs compete on the level of fees charged.³⁸ However, more than half of the issuers and a number of other users of credit ratings who responded to the Call for Evidence reported that frequent fee increases had been imposed by the largest CRAs operating globally for credit ratings and related data products and services ranging from 1% per annum to 300% over five years.
166. The profitability of credit rating activities seems to vary significantly between the CRAs operating in the EU, which suggests that their abilities to generate revenues and their cost structures may differ widely. In general terms, the CRAs operating in the EU

³⁵ ESMA/2015/1472, Technical Advice on Competition, choice and conflicts of interest in the credit rating industry, 30 September 2015 at page 43, available at: https://www.esma.europa.eu/sites/default/files/library/esma-2015-1472_technical_advice_on_competition_choice_and_conflicts_of_int.pdf.

³⁶ Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013 available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN>.

³⁷ Directive 2009/138 of 25 November 2009 on the taking up and pursuit of the business of Insurance and Reinsurance, OJ L 335, 17.12.2009, as amended by the Omnibus II Directive (Solvency II), available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0138&from=EN>.

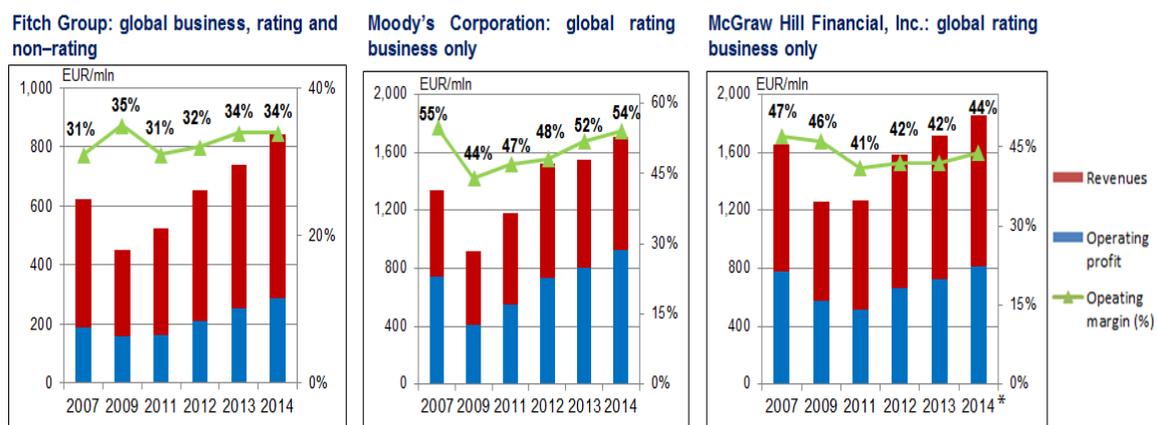
³⁸ Issuer responses to question 25 of the Call for Evidence.

can be divided into three groups on the basis of the revenues from credit ratings and ancillary services reported to ESMA:

1. CRAs generating revenues of less than €1 million a year;
2. CRAs generating revenues of between €1 million and €26 million a year, and;
3. CRAs generating revenues of over €100 million a year.

167. From the financial statements submitted to ESMA by 23 CRAs in 2014,³⁹ it appears that five CRAs fall into the first group, 15 fall into the second group and three fall into the third group. ESMA has raised concerns⁴⁰ that the three largest CRAs operating globally are able to generate revenues of this order and appear to be able to impose regular price increases on their customers without this resulting in a significant loss of business. Figure 11 below shows the relationship between the revenues, operating profits and operating margins of these three groups between 2007 and 2014.⁴¹

Figure 11: Changes in the revenues, operating profits and the operating margins of three largest CRAs operating globally



Source: ESMA elaboration based on published consolidated accounts (figures from Fitch Group based on Fimalac's consolidated annual reports). Figures of Moody's Corporation and McGraw Hill Financial, Inc. have been converted to EUR from USD based on monthly average exchange rate.
 * The 2014 figures for McGraw Hill Financial, Inc. do not take into account the impact of US legal and regulatory settlements on the group's operating profit and margins.

168. This figure shows that overall the revenues, operating profits and margins of these groups had returned to or exceeded 2007 levels by 2014. All three groups reported significant operating margins between 2009 and 2014. For Moody's these have increased materially, from 44% to 54% during this period, whereas they have fluctuated between 31% and 35% for Fitch and between 41% and 46% for McGraw Hill.

³⁹ ModeFinance, INC Rating Sp.Zoo and Rating-Agentur Expert RA were not registered as CRAs at the time these statements were submitted to ESMA.

⁴⁰ ESMA/2015/1472 Technical Advice on Competition, choice and conflicts of interest in the credit rating industry, 30 September 2015, available at https://www.esma.europa.eu/sites/default/files/library/esma-2015-1472_technical_advice_on_competition_choice_and_conflicts_of_int.pdf, last accessed 07.01.2016.

⁴¹ Please note that for Moody's Corporation (ultimate holding company of Moody's) and McGraw Hill Financial, Inc. (ultimate holding company of S&P) figures refer to the performance of rating business at global level. For the Fitch Group, figures refer to both rating and non-rating business combined at global level, since separate information for the credit rating business only is not publicly available.

5.3 Supervisory focus

169. As mentioned in paragraph 156 above, ESMA uses a risk-based framework to establish its annual work plan. The CRA risk assessment framework developed by ESMA includes traditional risk management concepts of probability and impact. The probability of a given risk materialising is assessed by ESMA using scorecards. These scorecards consider the likelihood that CRAs will face risks in key areas, for example regarding market conditions, their operations and their governance and strategy.

170. Once the probability of key risks materialising has been assessed, ESMA considers the likely impact that such a risk would have on the CRA and the industry as a whole, taking into account the size and importance of individual CRAs in European credit markets as a whole as well as in national markets. ESMA then establishes its supervisory priorities on the basis of those risks which are both high probability and high impact.

171. The risk assessments carried out in 2015 identified that ESMA should focus its supervisory activities for 2016 on ensuring that CRAs' compete and develop their businesses in compliance with the CRA Regulation, in particular as regards:

- governance and strategy; and
- the quality of credit ratings and credit rating activities.

172. In addition to its work in these areas, in 2016 ESMA will continue the investigations into the conduct of specific CRAs started during 2015 and will continue developing its internal IT tools and external systems, including the fees reporting module of RADAR referred to in Section 3 above.

5.3.1 Governance and strategy

173. CRAs' strategic business decisions, such as decisions to expand into new markets, frequently lead them to change their corporate and governance structures. In 2015, five CRAs proposed changes to their corporate structures or shareholder composition and a number of further structural and related governance changes are due to be made in 2016. These changes are largely driven by internal reorganisations, the introduction of new systems and processes, the desire to operate in additional geographic markets or to offer additional categories of credit ratings.

174. Partly as a result of these changes, the risk assessment exercises conducted by ESMA in 2015 identified high levels of governance and strategy risk in the CRA industry. In particular, these exercises highlighted a number of concerns about the impact of CRAs' business decisions and changes in shareholding and governance structures on the internal controls in place in CRAs.

175. In 2016 ESMA will examine the impact that CRAs' CRAs' governance and shareholder structures and business decisions have on their operations and internal controls to ensure that CRAs' business interests do not impair the independence of credit rating activities as required by Article 6(2) and Annex I Section A and B of the CRA Regulation.

176. ESMA will monitor the impact that organisational changes may have on the effectiveness of CRAs' compliance, internal audit and internal review functions, in order to ensure that they are implemented in a way which empowers these functions and facilitates their monitoring and reporting obligations. ESMA will also examine the role of internal control functions in CRAs more broadly, in particular as regards their responsibilities for monitoring and evaluating the adequacy and effectiveness of CRAs' systems and internal control mechanisms and the steps taken by these functions to address any deficiencies identified.⁴²

177. Furthermore, ESMA will consider how CRAs meet the requirements of Annex I Section B point 3c of the CRA Regulation which requires that the fees charged by CRAs shall not depend on the level of the credit rating issued by the CRA or on any other result or outcome of the work performed. This analysis will also feed in to the development of ESMA's strategy for the supervision of fees charged by CRAs for credit ratings and ancillary services together with the expert studies commissioned by ESMA in 2015. These studies are helping ESMA to appreciate that different approaches to the supervision of fees charged by CRAs may be needed in order to reflect the different types of CRAs operating in different geographic areas and the different business models used by these CRAs. ESMA will be mindful of the two sided nature of the markets for credit ratings in developing its approach to fee supervision and will consider the impact of changes in fees charged by CRAs not only on issuers, but also on investors and subscribers.

5.3.2 Quality of credit ratings and credit rating activities

178. A number of CRAs increased the volume of credit ratings that they issued in respect of particular asset classes in 2015, which could indicate increasing competition between CRAs in some areas. ESMA oversees the implementation of the CRA Regulation by CRAs to ensure that competition between CRAs results in benefits for issuers and users of credit ratings, such as increases in the quality and variety of services offered and lower fees.

179. ESMA recognises that issuing higher volumes of credit ratings can put pressure on CRAs' systems and resources. The risk assessment exercises carried out in 2015 identified high levels of operational risk within the CRA industry, which raises concerns for ESMA about the ability of CRAs to compete and to expand their businesses without this having a negative impact on the quality of the credit ratings they issue and the credit rating activities they conduct.

180. In addition to its regular monitoring of competition between CRAs and of credit rating performance indicators, in 2016 ESMA will examine the quality and accuracy of credit ratings issued by CRAs by using a range of statistical methods in order to ensure effective compliance with the CRA Regulation. This will include an analysis of whether CRAs are meeting the requirements of a number of different provisions of the CRA

⁴² As set out in Annex I Section A point 10 of the CRA Regulation.

Regulation regarding methodologies, models and key rating assumptions as well as of how these methodologies, models and key rating assumptions are being reviewed by CRAs' IRFs.

181. ESMA will build on its ongoing work on the validation of methodologies reported in Section 3.4.5 above by investigating how methodologies for particular asset classes have been developed, validated and applied by one or more CRAs. As a part of its work in this area, ESMA will in particular consider whether:

- some categories of credit ratings are being issued without following established methodologies or without conducting conventional credit rating assessments; and whether
- commercial concerns may influence the level of the rating issued or methodologies may be changed to win new business.

182. This will require an assessment of Article 8 of the CRA Regulation, and in particular whether CRAs are meeting the requirements of:

- Article 8(2) of the CRA Regulation, by adopting, implementing and enforcing adequate measures to ensure that their credit ratings and rating outlooks are based on a thorough analysis of all of the information that is available;
- Article 8(2a), which requires CRAs to ensure that any changes to credit ratings issued are made in accordance with published credit rating methodologies; and
- Article 8(3), which requires CRAs to use methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.

183. ESMA's work in this area will also consider whether CRAs' IT and analytical resources are sufficient to ensure continuity and regularity in the performance of its credit rating activities in accordance with Annex I Section A point 8 of the CRA Regulation or that effective control and safeguard arrangements are in place for information processing systems, in accordance with Annex I Section A point 4 of the CRA Regulation. The IT risk assessment performed during 2015 will provide the basis for determining whether specific supervisory actions need to be conducted regarding CRAs' use of IT during 2016. ESMA's work in this area will be carried out alongside similar work regarding TRs where ESMA identifies risks which apply to both sets of supervised entities, such as information security and resilience to cyber-attacks.

5.4 Trade Repositories

184. For the purposes of the 2016 supervisory work programme, ESMA applied a risk-based approach in order to identify and assess TRs' risks and exposures. The risk assessment exercise builds on the observed market trends and current state of the TR industry in the

EU. It assessed all the information available to ESMA, from information collected from previous supervisory activities such as requests for information; on-site inspections; thematic reviews or general investigations; as well as TRs' periodic reporting; notifications of material changes and incidents and information communicated by the NCAs or by counterparties and reporting entities.

185. The findings of the risk assessment demonstrated that the main risks identified relate to TR data quality and access to TR data. ESMA has already taken a number of measures regarding these risks in previous years, for example through its on-site inspections and the launch of its data quality action plan. However, the rising number of records collected by TRs and the increasing number of authorities accessing those records make this a risk which ESMA should continue to monitor closely in 2016.

186. The TR risk assessment also revealed concerns about the security of voluminous and sensitive information maintained by TRs, which needs to be carefully managed, particularly in the context of the current threats to information systems. Finally, the risk assessment exercise, through its assessment of ESMA's on-going financial analysis of TRs and of the changes in TR fee schedules, raised concerns regarding the financial risks faced by TRs.

187. As a result of ESMA's risk-based assessment, the following areas of supervisory focus have been identified for 2016:

- Data quality.
- Data access.
- Financial risk.
- Information security risk.

188. ESMA will follow-up on its work in these areas through individual and thematic investigations, including on-site inspections. With regard to ongoing activities such as the investigations related to data availability, ESMA intends to finalise these and monitor the implementation of remedial action plans.

5.4.1 Data quality

189. Given the role of TRs in financial markets, data quality is a major priority from both a financial stability and investor protection perspective. The introduction of level 2 data content validations in late 2015 means that ESMA's focus will be on further improving TR data quality throughout 2016. This also includes inter-TR reconciliation rates, and the accuracy and consistency of the aggregated data that TRs make publicly available.

190. Aggregated data quality strongly depends on the overall quality of the data reported to TRs and it is expected to further improve as a consequence of other initiatives related to the data quality action plan. During 2015 ESMA has been monitoring the quality of public data and it will continue to do so throughout 2016. Aggregated public data is

accessible to any interested user worldwide and any inconsistency can be easily lead to misinterpretations.

191. In November 2015, ESMA submitted amended technical standards on reporting⁴³ to the European Commission. Once these new standards are approved, ESMA will monitor the readiness of TRs for the implementation of the respective amendments related to data fields, including the introduction of new fields and values. Despite the fact that reporting under the amended technical standards is not expected to start until 2017, TRs and reporting entities will need to prepare for these changes well in advance so ESMA will need to supervise the progress and compliance of TRs' readiness within the agreed timeframes.

5.4.2 Data availability and access to Trade Repositories

192. The main objective of EMIR is to provide the competent authorities with information regarding the derivatives trades which enables them to fulfil their mandates and responsibilities. The risks related to access to TR data were already identified in 2014 and were taken into account when planning investigations conducted in late 2014 and throughout 2015. In 2016 ESMA will continue focusing on data availability and access to TRs. ESMA's work in this area will include the finalisation and monitoring of remedial action plans of TRs inspected as well as a consideration of the activities of other TRs regarding data availability and access to data.

5.4.3 Financial risks

193. In 2015 ESMA started monitoring the financial health of TRs. More specifically ESMA has assessed TRs' continued ability to comply with Article 21 of the regulatory technical standards specifying the details of the application for registration as a TR.⁴⁴ This provision requires a TR to hold sufficient equity to cover general business losses and to provide services as a going concern, to help ensure it has sufficient financial resources to cover the operational costs of a wind-down or reorganisation of the critical operations and services for a period of at least six months.

194. In 2016 ESMA will continue monitoring three major factors: liquidity, leverage, and profitability of TRs, which are measured by means of specifically selected financial ratios. While TRs are typically part of a group structure it remains necessary for ESMA to monitor the sufficiency of financial resources and their allocation of costs. Developing an understanding of cost allocation is also important for the assessment of TRs' fees. In 2016, ESMA will focus on the cost-relatedness of fees charged by TRs, as this is a requirement of Article 78(8) of EMIR.

⁴³ ESMA 2015/1645, Review of the Regulatory and Implementing Technical Standards on reporting under Article 9 of EMIR, available at: https://www.esma.europa.eu/system/files_force/library/2015/11/2015-esma-1645-final-report-emir-article-9-rti-its.pdf

⁴⁴ Commission Delegated Regulation 150/2013 of 19 December 2012 supplementing Regulation 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards specifying the details of the application for registration as a trade repository.

5.4.4 Information security

195. In 2016, ESMA will complete its analysis of the thematic TR cyber resilience review launched in 2015 and will carry out a number of follow up activities in 2016. ESMA will also finalise the remedial action plans arising from the on-site inspections performed in 2015 and 2014 relating to these issues and will monitor implementation of these remedial actions.

5.5 Common areas of focus

196. From the priorities identified above, there are two areas of focus which will be common to the supervision of both CRAs and TRs in 2016: information security and fees charged by supervised entities.

197. The first area of common focus for both CRAs and TRs relates to information security. The risk assessment exercises carried out by ESMA have identified that some of the highest risks faced by all supervised entities are related to their IT systems and processes. The Supervision Department will work to ensure that supervised entities have effective systems in place to ensure the secure exchange of information in their operating environments and their resilience to cyber-attacks.

198. The second area of common focus relates to fees, as both the CRA Regulation and EMIR contain requirements about the fees which supervised entities charge to their clients. The CRA Regulation requires CRAs to ensure that fees charged for credit ratings and ancillary services are non-discriminatory and are based on actual costs, in accordance with Annex I Section B 3c of the Regulation. Article 78 of EMIR requires fees charged by TRs to be transparent, non-discriminatory and based on the actual costs of providing services.

199. ESMA is considering its approach to the supervision of fees charged by the entities that it supervises, for both their core services and ancillary services. ESMA recognises that the supervision of fees charged in the CRA industry and the TR industry need to be tailored to reflect the different objectives of the CRA Regulation and EMIR and the differing market dynamics in the two industries. However, combining its work in this area will allow ESMA to develop a consistent overall strategy for ensuring that it conducts its supervision in a way which maximises investor protection, financial stability and orderly markets.

200. ESMA will take the opportunity to publish thematic reports where appropriate, for example to provide market participants with data and statistics, to convey messages of general application to market participants or to encourage greater compliance with the spirit and the letter of the regulations supervised by ESMA.

6 Conclusion

201. This report has highlighted the supervisory activities carried out by ESMA during 2015 regarding CRAs and TRs and sets out some of ESMA's main supervisory priorities for 2016 in each of these areas.

202. The report notes the changes made to the way in which ESMA carries out its supervision following the publication of its strategic orientation for 2016-2020. It explains the creation of a dedicated Supervision Department within ESMA to build on the expertise that has been developed since it assumed its first supervisory responsibilities in 2011. The report also highlights the steps taken to increase ESMA's use of risk-based supervision and refers to some of the key supervisory actions taken in 2015.

203. Regarding the supervision of CRAs, ESMA's key achievements include the registration of three new CRAs and the imposition of the first fine against a CRA for failure to comply with the requirements of the CRA Regulation. ESMA has also prepared guidance and Q&As to help promote uniform reporting by CRAs and has successfully concluded a number of investigations into the process of issuing credit ratings, the validation and review of credit rating methodologies, and an assessment of the IT risk faced by some CRAs.

204. Regarding the supervision of TRs, in 2015 ESMA carried out extensive supervisory work to improve the quality of the data submitted to TRs, access to data held by TRs, and the operation and performance of TRs' systems.

205. ESMA has used a risk-based approach to identify a number of key areas on which it will focus its supervisory activities in 2016. These are similar to the areas identified in 2015, including:

- CRAs' governance and strategy.
- The quality and accuracy of credit ratings.
- The quality of TR data.
- Access to TR data.

206. In addition, ESMA has identified that there are a number of areas which raise issues that are common to all supervised entities, such as their approaches to information security and the fees charged to customers for both core and ancillary services.

207. Furthermore, in 2016, ESMA will continue to develop specific tools to increase its internal data centralisation and information processing capabilities. This will enhance ESMA's analytical capacity and promote more detailed and more regular risk assessment and prioritisation.

208. ESMA will make use of all the supervisory tools at its disposal to achieve its objectives, from market monitoring and intelligence gathering to on-site inspections and

investigations. ESMA notes that complaints and market intelligence are a valuable source of information and encourages market participants to contact ESMA using the forms available on the ESMA website.⁴⁵

209. ESMA will also publish thematic reports to clarify its expectations on issues of interest to all supervised entities in appropriate cases. These thematic reports may be an effective means of disseminating industry data and statistics as well as helping to stimulate the development of a culture of compliance within supervised entities.

210. In 2016 ESMA will also seek to build on its international work so that it can benefit from the experience of its fellow supervisors and will enter into cooperation agreements and Memoranda of Understanding to promote information sharing and joint investigatory work where possible.

⁴⁵ For CRAs, please refer to: <https://www.esma.europa.eu/supervision/credit-rating-agencies/supervision>. For TRs, please refer to: <https://www.esma.europa.eu/supervision/trade-repositories>.