Credit Rating Agencies

ESMA's investigation into structured finance ratings

16 December 2014 | ESMA/2014/1524

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Acronyms used

ABS	Asset-Backed Securities
CEREP	Central Repository
CDO	Collateralised Debt Obligation
CMBS	Commercial Mortgage-Backed Securities
CRA	Credit Rating Agency
CRA Regulation	Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies of 16 September 2009 and subsequent amendments.
ECB	European Central Bank
EU	European Union
PFI	Project Finance Initiative
RMBS	Residential Mortgage-Backed Securities
RTS	Regulatory Technical Standards
SME	Small and Medium-sized Enterprise
WBS	Whole Business Securitisation

1 Executive Summary

Reasons for publication

The European Securities and Markets Authorities (ESMA) has published this report to inform of the outcome and findings of its general investigation in the way credit rating agencies (CRAs) conduct surveillance of structured finance credit ratings, as indicated in ESMA's Credit Rating Agencies Annual Report 2013[1]. The investigation took place between October 2013 and September 2014 and involved the four largest CRAs providing credit ratings on structured finance instruments in the EU, namely DBRS Ratings (DBRS), Fitch Ratings (Fitch), Moody's Investors Service (MIS) and Standard & Poor's (S&P).

Outcome and findings of the investigation

ESMA's interest in the structured finance credit ratings is consequent to the relevance of structured finance, and more generally securitisation, in the financial industry as an important alternative funding source and risk-transfer tool. Despite the reduced issuance of structured finance instruments following the financial crisis, outstanding volumes remain high, and signs of renewed support for securitisation in Europe may lead to future growth in this area.

During its investigation, ESMA identified shortcomings and weaknesses, as well as examples of good practices, in several areas affecting the surveillance of structured finance ratings for each CRA investigated. As the shortcomings identified may jeopardise the quality of credit ratings, ESMA expects CRAs to enhance their practices in various areas highlighted by the investigation. Moreover, ESMA identified shortcomings on the level of disclosure and transparency which could be detrimental to investor protection. The outcome of the investigation is of particular relevance given that the four CRAs involved account for almost 100% of the total outstanding credit ratings of EU structured finance instruments.

Critical issues that ESMA identified in one or more CRAs include:

- the lack of quality controls over information used and received from data providers;
- incomplete application of the full methodology during the rating monitoring process aggravated by insufficient disclosure of the different analytical frameworks used;
- delays in the completion of the annual review of ratings;
- need to strengthen the role of the internal review function and the activities it performs during the review of methodologies, models and key rating assumptions applied to structured finance ratings in order to ensure effective independence from the business

[1] Esma/2014/151 (21 February 2013) - Credit Rating Agencies annual report 2013 and work plan for 2014 and beyond.

lines responsible for credit rating activities.

ESMA has requested that individual CRAs put in place remedial action plans to resolve the individual concerns identified. In some instances the CRA involved has already taken remedial steps to address the issues identified.

The findings and considerations contained in this report are general in nature and so are likely to be applicable to a variety of ratings issued by CRAs, not just the RMBS ratings which were the subject of this investigation.

All registered CRAs should therefore take note of the issues identified in this report to ensure that they properly incorporate the requirements and the objectives of the Regulation into their working practices and remove any practices and procedures which conflict with these.

ESMA will follow up with each of the CRAs subject to this investigation individually to ensure that the issues identified in this report are resolved appropriately. Likewise, ESMA will monitor all other registered CRAs as part of its on-going supervision.

ESMA has not determined, as at the date of this document, whether any of the findings described in this report may indicate one or more potential infringements of the CRA Regulation (the Regulation). The report is therefore published without prejudice to ESMA's ability to conduct further investigations which could lead to future supervisory or enforcement action.

2 Who should read this report

ESMA uses a wide range of regulatory, supervisory and enforcement tools, including remedial action plans and public reports of this kind, to raise standards in the CRA industry in the pursuit of its regulatory objectives.

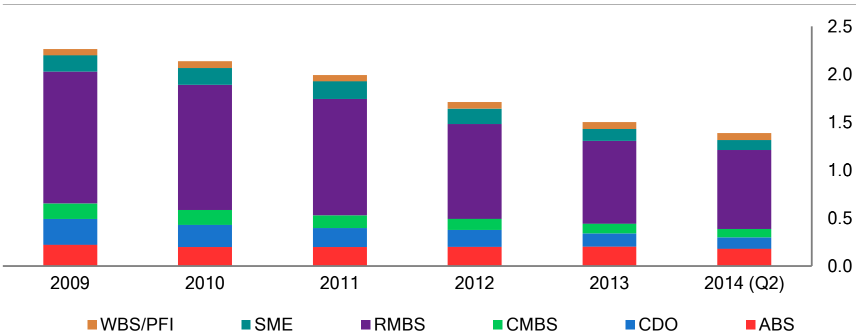
This report is addressed to registered CRAs and prospective applicants for registration and a variety of ratings users, including institutional and retail investors, investment firms, asset management firms, all debt issuers, central banks, public authorities, governments and supervisory bodies and other ratings industry stakeholders.

The observations contained in this report are of relevance not only to the CRAs involved in this investigation, but also to any other CRAs registered with ESMA and subject to its supervision, as well as entities planning to apply to ESMA to become registered CRAs. It is essential that all registered CRAs embed the objectives of the Regulation in their organisation and that they remove any existing practices and procedures which conflict with these objectives.

3 Rationale for conducting the investigation

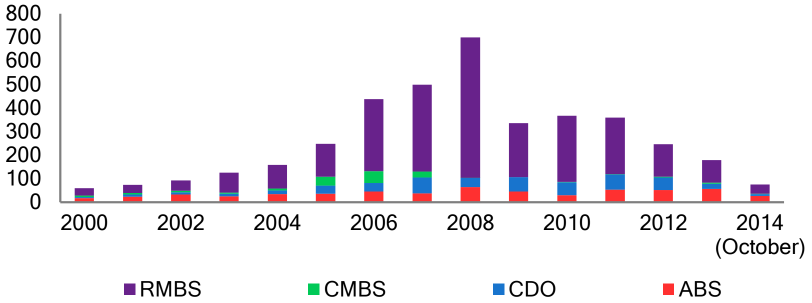
ESMA focused its investigation on CRAs' surveillance of structured finance ratings, based on the large volume of structured finance transactions outstanding (Chart 01) despite the reduced issuance following the financial crisis (Chart 02). In particular, ESMA's investigation focused on ratings of RMBS, as the largest asset class within the structured finance category.

Structured Finance outstanding volume by collateral (Eur trillion) Chart 01



Note:: Volume outstanding in EU, both placed and retained
Sources: AFME, ESMA

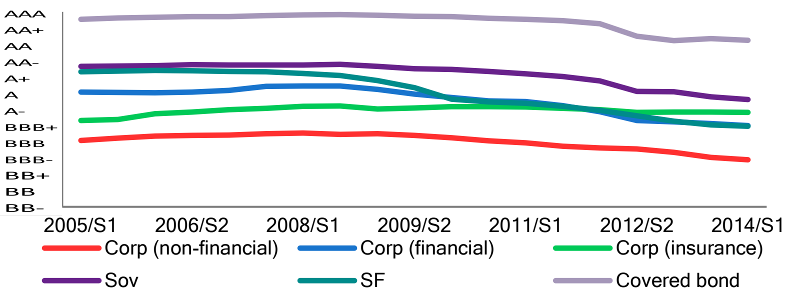
Structured Finance issuance volume by collateral (Eur billion) Chart 02



Note: volume issued in EU, both placed and retained
Sources: Bloomberg, ESMA

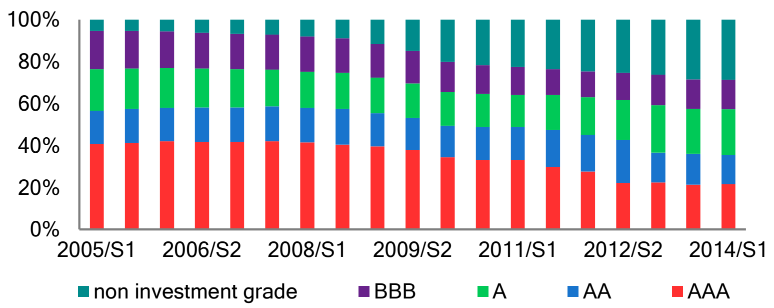
During the financial and subsequent sovereign debt crises the average rating of several classes of credit ratings in the EU deteriorated, with the exception of corporate ratings on insurance undertakings, although the magnitude of the decline varied between the different classes (Chart 03). Structured finance ratings experienced the most pronounced drop as the average rating fell by almost 4 notches (from AA- to BBB+) since the second half of 2007, and the proportion of non-investment grade transactions increased from 6% at pre-crisis level to 29% in 2014 (Chart 04).

Average credit rating by asset class Chart 03



Note: Credit ratings issued in the EU; average rating at the beginning of the observation period
Sources: CEREP, ESMA

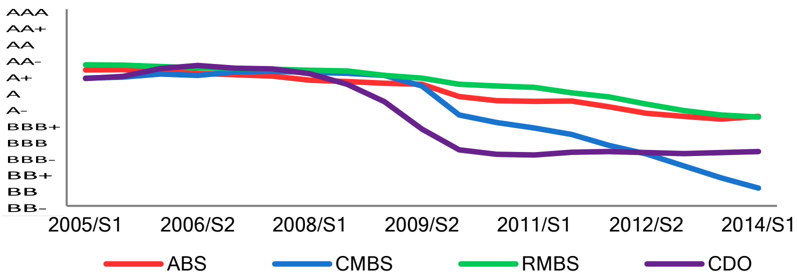
Structured Finance credit rating distribution Chart 04



Note: Credit ratings issued in the EU; distribution at the beginning of the observation period
Sources: CEREP, ESMA

The most common individual sub-asset classes in the structured finance category (i.e. RMBS, ABS, CMBS, CDO) experienced differing degrees of decline during the financial crisis although their average ratings prior to 2007 were very much aligned. Specifically, RMBS and ABS exhibited more stable ratings compared to CDO and CMBS which experienced a more substantial reduction in the level of ratings (Chart 05).

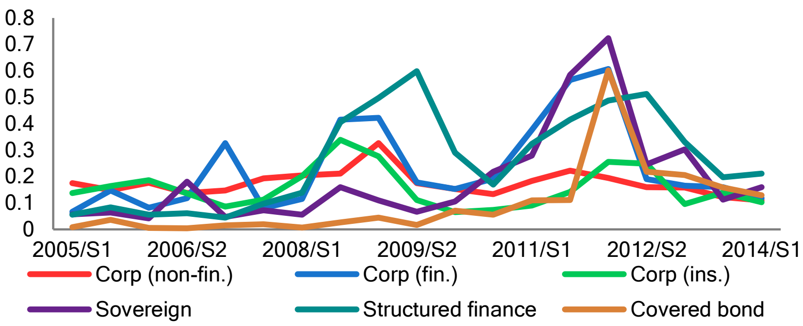
Average credit rating by Structured Finance category Chart 05



Note: Credit ratings issued in the EU; average rating at the beginning of the observation period
Sources: CEREP, ESMA

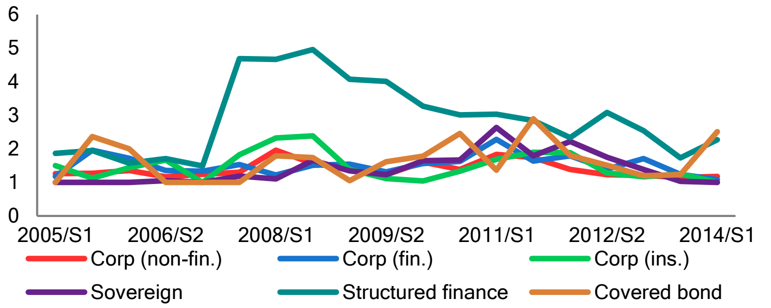
Other indicators, such as the volatility of ratings and the average size per downgrade (or upgrade) per rating action (Charts 06 and 07), show that the structured finance category is an outlier and performs worse than other asset classes. In particular, the aforementioned metrics peaked for structured finance ratings during the financial crisis. Notably the data submitted semi-annually by CRAs to CEREP shows that structured finance instruments subject to downgrades experienced a peak in the notches cut in the range of 4.5/5 for each reporting period between July 2007 and December 2008 (i.e. three submissions of data by CRAs).

Notch-weigthed volatility Chart 06



Note: notch-weighted upgrades and downgrades divided by numbers of credit ratings outstanding
Sources: CEREP, ESMA

Number of notches cut occurred per reporting period (6 month) Chart 07



Sources: CEREP, ESMA

Despite the decline in the issuance of new structured finance instruments since its peak in 2008, renewed support for securitisation in Europe is likely to mean that the ratings of these asset classes will continue to have systemic importance in the future.

4 Scope of ESMA's investigation

In light of the market context described in Section 3, and considering the large outstanding volume of structured finance products, ESMA deemed it necessary to verify whether CRAs' monitoring practices for structured finance credit ratings fulfilled the regulatory objectives. ESMA decided to focus its investigation on the surveillance of RMBS ratings, given their relative importance when compared to other types of structured finance instruments.

The investigation was conducted on four CRAs, namely DBRS, Fitch, MIS and S&P, on the basis of their coverage of the structured finance rating market. The largest three CRAs — Fitch, MIS and S&P — currently have a combined market share of outstanding structured finance credit ratings above 95% (Table 01). While their combined market share was 100% of ratings issued up to the financial crisis, it has slightly decreased in recent years as a result of few new market participants, of which DBRS has the largest market share (Table 02).

CRAs' market share in Structured Finance (by number of outstanding ratings in the EU) Table 01

	2005 H1	2008 H2	2010 H2	2012 H2	2014 H1
DBRS	0%	0%	1%	3%	4%
FITCH	36%	36%	34%	33%	33%
MIS	33%	31%	31%	31%	30%
S&P	31%	33%	34%	33%	33%
4 CRAs' cumulative market share of total outstanding ratings	100%	100%	100%	100%	100%
Total number of outstanding SF ratings	10,576	19,281	17,334	15,566	13,651

Note: H1 refers to first half of the year (January-June). H2 refers to second half of the year (July-December)
Source: CEREP, ESMA

CRAs' market share in SF (by number of new ratings in the EU)			Table 02
	2005 H1 - 2008 H2	2008 H2 - 2014 H1	2012 H2 - 2014 H1
DBRS	0%	10%	19%
FITCH	35%	24%	29%
MIS	30%	31%	23%
S&P	34%	35%	28%
4 CRAs' cumulative market share of total new ratings	100%	100%	99%
Total number of new SF ratings in the period	15,468	7,057	1,857

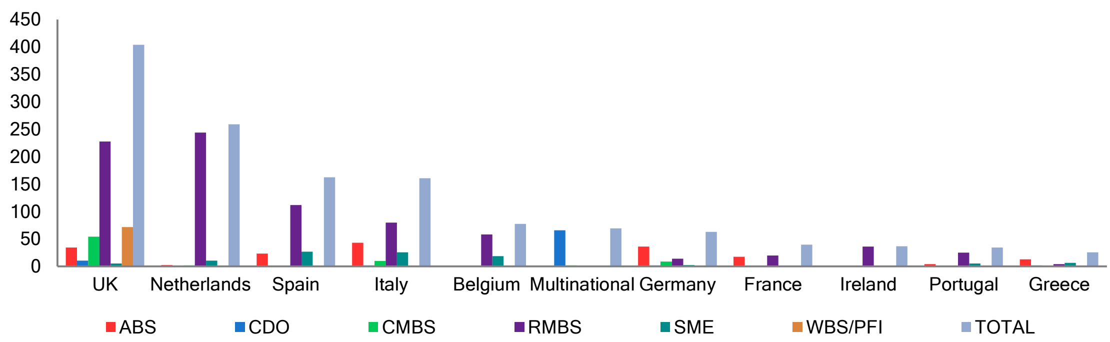
Source: CEREP, ESMA

ESMA's investigation looked in particular at those key aspects applicable to all RMBS ratings and not just those affected by the specifics of an individual transaction, including:

- the methodologies applied during surveillance;
- the analysis performed;
- the information used;
- the disclosure practices;
- the independent review of methodologies, models and key rating assumptions.

In order to gain a clear understanding of how CRAs' framework as described in their procedures, internal guidelines, and rating methodologies is applied in practice, ESMA also looked at a sample of RMBS transactions selected from the three largest RMBS markets within the EU, namely the UK, Spain and the Netherlands (Chart 08).

European SF - balance outstanding volume by collateral and country (Eur billion) Chart 08



Note: Data at 2014 Q2, volume outstanding in EU, both placed and retained
Sources: AFME, ESMA

ESMA's initial request for information, sent to CRAs in October 2013, covered the period between January 2011 and August 2013 and referred to information on the following topics:

- resources allocated to monitoring activities;

- initiation of the monitoring process and information used;
- credit rating monitoring procedures and methodologies;
- rating monitoring and rating actions for Dutch, Spanish and UK RMBS credit ratings;
- reports produced by Compliance, Internal Review and Internal Audit departments;
- fees charged for monitoring activities[2].

ESMA's investigation consisted of a desk-based examination of CRAs' internal records and an on-site inspection at the CRAs' premises.

During the on-site inspections ESMA conducted interviews with analytical staff involved in the structured finance rating decisions as well as with representatives from non-rating functions (business development, operations, internal review and compliance).

ESMA has communicated its observations to each CRA on a confidential basis. Individual remedial action plans and their timelines have also been established.

Finally, ESMA has given the CRAs involved in this investigation the opportunity to comment on any possible factual inaccuracies in the report prior to its publication.

5 Key findings

The sections below outline the key findings of ESMA's investigation into the monitoring of RMBS ratings. In the course of the investigation, ESMA also observed some good practices, described in the relevant sections, which can serve as input for both CRAs already active in the structured finance rating business, as well as CRAs planning to enter this market.

The findings described, including the good practices noted, apply to a varying extent to one or more of the CRAs investigated and are grouped into the following areas:

- quality controls over the information provided by third parties and used in the rating process;
- systematic application of methodologies and thorough analysis of relevant information;
- annual review of ratings and timeliness of publication;
- disclosure of information on rating assessments and methodologies;

[2] ESMA does not report any findings about fees charged by CRAs in this report. However, the information collected was used to improve ESMA's knowledge of fees structures, which assisted in the development of the draft Regulatory Technical Standards for the periodic reporting on fees charged by credit rating agencies for the purpose of on-going supervision by ESMA, adopted by the European Commission on 30 September 2014.

- independence of the internal review function responsible for the periodic review of methodologies, models and key rating assumptions; and

- resources.

5.1 Controls on the quality of information and related disclosure

ESMA has concerns that CRAs do not implement sufficient measures to ensure that the information used in the rating process is of sufficient quality and comes from reliable sources.

5.1.1 Assessment of due diligence processes on the underlying assets of structured finance instruments

The credit ratings of RMBS, and of structured finance instruments more generally, are heavily dependent on the quality of the assets underlying the structured product. Information on those underlying assets is provided to CRAs by third parties. In order to issue credit ratings of sufficient quality, it is crucial that the information used as the basis of CRAs' rating analysis is of sufficient quality and comes from reliable sources.

In all cases, the Regulation requires CRAs to refrain from issuing a credit rating, or to withdraw an existing rating, if the quality of information available is unsatisfactory. Furthermore, the Regulation requires CRAs to disclose the extent to which they verified the information provided by the rated entity or related third party for each credit rating.

ESMA identified several shortcomings and prospective areas for improvement in relation to the controls CRAs performed on the information used during the rating assessment and its quality.

Whilst the Regulation does not require a CRA to conduct its own assessment of the due diligence processes on the underlying assets of a structured finance instrument, it establishes specific disclosure requirements in this area. A CRA shall disclose whether it has undertaken any assessment of such due diligence processes or whether it has relied on a third party's assessment of the due diligence processes, as well as how the outcome of such assessment impacted on the credit rating (point 2 of Annex I, Section D, Part II of the Regulation).

On this area, ESMA highlights the following observations and related shortcomings:

- ESMA found that one or more CRAs do not ensure that information on the due diligence of the underlying assets, or alternatively the assessment performed by a third-party, is systematically requested and obtained for all transactions. The absence of a CRA or third party assessment of the due diligence processes carried out at the level of underlying assets, in ESMA's view prejudices the CRA's ability to conclude whether information on those assets is of sufficient quality and comes from reliable sources.

- ESMA also noted that, while some CRAs have enhanced the process of collecting such due diligence or third party assessment for new ratings, the same information is not always available for outstanding ratings issued before the entry into force of the Regulation.

- In addition, ESMA found that one or more CRAs do not provide clear guidance to analytical staff on how information quality considerations should be incorporated in the credit rating analysis, including in cases where there are no due diligence assessments.

- ESMA also identified shortcomings in the way CRAs disclose to the public the extent to which the information provided was verified, whether the CRAs assessed the due diligence provided or relied on a third party assessment, and how such assessments impacted the credit rating.

ESMA has requested or recommended one or more CRAs to implement corrective measures to address the aforementioned issues.

- CRAs need to ensure that disclosures are made for each individual credit rating, including as regards assessments of the quality of information received and the impact on ratings.

5.1.2 Controls performed to assess the quality of information

Further on the controls CRAs perform on the information used during the rating assessment and its quality, in ESMA's view, one or more CRAs need to improve the scope and the systematic application of their information quality controls.

In particular, ESMA identified two areas where information quality controls were unsatisfactory:

i) information on counterparties to RMBS transactions;

ii) updated loan-by-loan data.

- For both areas, ESMA found that one or more CRAs did not systematically review and update the related relevant information during annual rating reviews and, where applicable, discuss it in rating committee meetings.

- In the area of counterparties, ESMA identified cases where the list of counterparties involved in the rated transaction, their credit worthiness, or the associated operational risk was not systematically reviewed and updated.

- Regarding the most up-to-date loan-level data, ESMA notes that one or more CRAs do not typically check the aggregated performance data periodically received from data providers against the updated loan-by-loan information. In ESMA's view, performing such checks is an important control on the quality of the data used during rating monitoring and would give an indication of the reliability of the data provider.

- ESMA observed that CRAs receive periodic data on pool performance (i.e. aggregated data) and loan-by-loan data that feed into CRAs' systems. While ESMA recognises that providers still deliver data in a variety of formats which requires further work by CRAs, ESMA observed that one or more CRAs were highly dependent on manual controls, which resulted in incomplete data checks and an increased risk of error. ESMA also observed cases where errors were reported in a highly automated environment, where such automation is not sufficiently analysed or reviewed by experts.

In relation to the latter, ESMA observed as good practice:

- a control framework which uses highly automated systems in the first stage after data receipt (for identification of errors and alerts), further integrated with expert intervention (e.g. dedicated data group or analyst intervention) through information controls performed in subsequent stages of the rating process.

ESMA has requested or recommended CRAs to implement corrective measures to address the aforementioned issues.

- ESMA has requested one or more CRAs to enhance their procedures for assessing the quality of information and on how the outcome of their assessment is taken into account in rating decisions.

- ESMA has also requested one or more CRAs to ensure, where applicable, that rating committees (including rating committee documentation) give sufficient relevance and consideration to this matter.

5.2 Application of methodologies, annual reviews and related disclosures

ESMA observed that the surveillance process that one or more CRAs use for reviewing RMBS ratings differs from the assessment performed when the rating is first issued. The differences are related to several elements of the analysis undertaken, including the type of data and models used as well as the key rating factors assessed.

5.2.1 Thorough analysis of all relevant information and systematic application of methodologies

ESMA found that, for on-going surveillance and annual review purposes, one or more CRAs do not systematically use either up-to-date loan-level data or the key models which are employed at inception to assess the expected loss and cash flow projections of the transaction. During the surveillance phase, ESMA found that one or more CRAs use simplified analytical tools or models which are fed by aggregated data on the performance of the underlying asset pool. This simplified approach does not envisage the systematic use of updated loan-by-loan data, albeit that such information is commonly available, and does not require the revision of cash flow projections.

In ESMA's view, applying the full methodology at least annually supports a more thorough and robust analysis, whereas the partial application of the methodology or the implementation of a simplified approach during the annual review of credit ratings raises concerns for ESMA regarding the quality of ratings and disclosure.

- Firstly, in ESMA's view, there is a risk that the two different approaches, which are based on different data inputs and models/tools, do not produce the same outcome. Discrepancies in outcomes might impact rating assessments and therefore pose risks to the accuracy and quality of the credit ratings. CRAs therefore need to ensure that using different analytical approaches does not lead to different results.

- Secondly, there is a lack of or insufficient public disclosure of CRAs' methodologies for the type of assessment conducted and the different models or tools used for monitoring purposes compared to those used to initially assign ratings. Neither the press release nor the rating action comment provides rating users and investors with the necessary clarity on the type of analysis performed.

ESMA notes that the IT systems used by CRAs show varying degrees of flexibility and usability. To that regard, ESMA noted as an example of good practice:

- the use of IT systems which allow for the running of the CRAs' expected-loss and cash-flow models each time updated loan-level data is received.

ESMA has requested or recommended CRAs to implement corrective measures to address the aforementioned issues.

- CRAs need to ensure that, during the surveillance phase of structured finance ratings, methodologies are systematically applied and that rating users have the necessary clarity on the analysis performed by the CRA.

- As to the use of different types of analysis, ESMA notes that the analysis of aggregated performance data, instead of loan-level data is able to provide valuable information quickly, particularly when applied to a static portfolio. ESMA sees the benefit of undertaking such analysis when performance data is provided by trustees or servicers, typically quarterly.

  Nevertheless, in ESMA's view only the use of the same, though more complex, models used at rating inception can ensure a robust and over time consistent annual review, the purpose of which is to assess whether credit ratings of all outstanding notes are correctly positioned taking into consideration deal specific peculiarities.

5.2.2 Annual review of credit ratings and timely publication

The previous section focused on the data and analytical tools and models used by CRAs and how they differ during the monitoring phase compared to when the rating is first assigned. The Regulation requires credit ratings to be based on a thorough analysis of all the information available to the CRA and relevant to its analysis according to applicable rating methodologies (Article 8.2). The Regulation further requires CRAs to review their credit ratings at least annually (Article 8.5).

- ESMA found that one or more CRAs did not review all the key factors described in their published methodologies, including the list of all transaction counterparties and their assessment, the operational / servicing risk or the legal risk.

- Furthermore, ESMA identified shortcomings in the record keeping and the descriptions in annual review documents with regard to the information used and the assessment performed on such key rating factors.

- ESMA also has concerns regarding the timeliness of annual rating reviews or the dissemination of ratings. For example, ESMA found cases of significant delays between CRAs' making rating decisions and the publication of a rating action or CRAs leaving ratings with an 'under-review' status for prolonged periods of time. These practices raise concerns about the effectiveness of the related controls put in place by one or more CRAs.

ESMA observed examples of good practice as well.

- For instance, one or more CRAs require all ratings to be reviewed at least once a year by a rating committee.

- One or more CRAs require the annual review to be finalised through the publication of a press release or rating action comment.

- Another good practice is to provide evidence in the rating committee documentation of the assessment performed for each key rating factor.

ESMA has requested or recommended CRAs to implement corrective measures to address the aforementioned issues.

- CRAs need to ensure that, during the surveillance phase of structured finance ratings, they perform a thorough analysis of all the information available and relevant to their rating assessment, including a review of all the key factors identified by the rating methodologies, and that such review is appropriately recorded.

- Whilst ESMA acknowledges that some rating factors might remain unchanged between successive reviews, ESMA sees the importance of documenting the assessment of each key rating factor made by CRAs during their annual review, including when these factors remain unchanged compared to their previous assessments. This would increase the accuracy, consistency and completeness of both the rating analysis and the recording of this analysis.

5.3 Independence of the internal review function

With regard to the CRAs' internal review function, the Regulation assigns to that function the responsibility of periodically reviewing CRAs' methodologies, models and key rating assumptions, as well as requiring the independence of the review function from the business lines responsible for credit rating activities (Point 9 of Section A of Annex I of the Regulation).

The documentation assessed by ESMA and the related interviews conducted during the on-site inspections raise concerns that such independence is not ensured by one or more CRAs, in light of the processes, practices and escalation rules being applied.

ESMA found that, in one or more CRAs, the involvement of the analytical function in the review process, including the responsibilities assigned, the type of activities performed and approval powers granted, has the potential to undermine the review function's independence and does not ensure that the periodic review of methodologies, models and key rating assumptions are conducted independently from the business lines responsible for credit rating activities.

- For instance, ESMA found that in one or more CRAs the analytical staff applying the methodologies, models and key rating assumptions on a daily basis as part of the credit rating analysis are also responsible for performing key review activities, such as model testing or drafting annual review documents, while the review function remains responsible for checking the outcome of activities performed by the analytical function.

- Furthermore, in one or more CRA, members of the analytical team have been given voting rights in the committees approving/validating the models used in the rating process.

- ESMA also found that one or more CRAs do not, or not sufficiently, document the activity performed annually by the review function to ensure that credit rating methodologies are and remain rigorous, systematic, continuous and subject to validation.

ESMA observed examples of good practice.

- For instance, one or more CRAs produce a detailed report for each review conducted by the independent review function. Such report describes the activities performed by the review function, its conclusions, and if appropriate, recommendations and implementation plan.

- With respect to the internal review process, ESMA identified as good practice that an independent standing committee discusses and finalises all annual reviews of methodologies without limiting its involvement to a selected number of cases (e.g. material changes of methodologies).

ESMA has requested or recommended CRAs to implement corrective measures to address the aforementioned issues.

- ESMA expects CRAs to adopt the examples of good practice described previously and has also requested that one or more CRAs enhance their current processes where these could be detrimental to the independence of the review function and the activity it performs with respect to the review of methodologies, models and key rating assumptions.

- ESMA also expects that, when the Regulation mandates the segregation and independence between the CRAs' internal review and analytical functions, CRAs should aim not only for formal structural separation but also for effective separation in practice. Internal controls and processes should be implemented and documented in order to demonstrate compliance.

5.4 Resources

With regard to the adequacy of resources and the experience of the analysts in charge of the surveillance of RMBS ratings, ESMA observed that the analytical framework implemented by CRAs for monitoring purposes also impacted how the analytical function is structured, in terms of both the number of staff and their relevant experience.

For instance, ESMA found that one or more CRAs appoint more junior staff to monitor structured finance ratings compared to when the rating is first assigned. In some cases such situations resulted in the analyst responsible for monitoring a transaction being unable to vote in the rating committee assessing that same transaction, due to their lack of seniority.

Another observation refers to the size of the rating portfolio of RMBS surveillance analysts, which is significantly larger when compared to analysts' portfolios in other asset classes or for new RMBS issue ratings.

The considerations included in this report highlight concerns about the resources currently assigned by CRAs to the RMBS rating monitoring process, and to the monitoring of structured finance ratings more generally.