European Securities and Markets Authority

Credit Rating Agencies

Annual Report 2013

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European Securities and Markets Authority

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Index

1. Introduction

Impact of CRA supervision – progress made but still much to do

In July 2013, the European Securities and Markets Authority (ESMA) completed its second year as the supervisor of EU-registered credit rating agencies (CRAs). As a recently formed regulator, the key questions ESMA must ask itself at this stage are:

- whether it has made, or is making, a difference;
- what progress it has made not only against ESMA's annual work plan objectives, but also against its wider objectives;
- where ESMA should focus its efforts on over the coming years; and
- whether the CRAs practices and the confidence in such an important segment of the financial system have improved.

The concept of regulating CRAs through a centralised EU regulator emerged in the aftermath of the first phase of the global financial crisis. A single regulator was seen as essential to address fundamental concerns about the nature of the industry and, in particular, its transparency and integrity.

The new EU regime created with the CRA Regulation (Regulation) supports the principles of integrity, transparency, responsibility and good governance on which CRAs' credit rating activities should be based. It also emphasises the importance of robust internal controls, conduct of business rules, and the disclosure requirements for methodologies, models and rating assumptions.

ESMA's immediate challenge as a supervisor was to assess the state of play in the industry, build up its supervisory resources, and define how its approach to supervision would deliver the Regulation's over-arching principles in order to ensure the quality and independence of the rating process.

The *First Step General Investigation*[1], rolled out in December 2011, was designed with these objectives in mind and proved invaluable in identifying which particular issues deserved further supervisory attention.

A thematic investigation into the bank rating methodologies and related processes of several CRAs followed in 2012; its outcome included remedial action plans established for each CRA, which were implemented during 2013. ESMA also analysed the governance in a single CRA; this

[1] In the report, we refer to general, thematic or individual investigations. Investigations are supervisory activities which ESMA may undertake to carry out its duties under the Regulation (Article 23c).

individual investigation provided valuable insights also used for the assessment of small and medium-sized CRAs which was one of the main activities in 2013.

We continued to assess the transparency and integrity of the industry through the sovereign ratings process thematic investigation in 2013, which, like previous investigations, resulted in the imposition of challenging action plans for each of the CRAs included in the investigation.

As well as multiple CRA and single subject vertical reviews, in 2013 we continued to build on the engagement cycle introduced in 2012 with the intention of setting out a regular programme of interaction with individual CRAs. In 2014, we will enlarge the scope of the engagement programme through regular discussions on business strategy and regulatory matters with the Chief Executive Officers of the larger CRAs.

In parallel we continue to expand our regulatory toolbox to include communication documents which offer more transparency about our expectations about the conduct of CRAs. In 2013 this included the: i) guidelines and recommendations on the scope of the Regulation; ii) Q&As on the implementation of the Regulation; iii) publication for the first time of information highlighting areas of good practice observed in the three largest CRAs during the thematic investigation into their sovereign rating processes.

Looking back over the period since 2011, our priority has been to test the extent to which CRAs have set in place, and embedded in their organisation, policies and practices that meet the Regulation's requirements.

The Regulation places great responsibility upon CRAs and ESMA. What ESMA expects from, or demands of, CRAs is driven by the recognition that credit rating activities conducted in accordance with the principles set by the Regulation contribute to restoring trust and confidence of investors and consumers.

In our drive to achieve more lasting and genuine change where necessary in CRAs, we continuously focus on the special responsibilities conferred by the Regulation on independent members of the administrative or supervisory body (INEDs). While many smaller firms have an exemption from the need to have INEDs, this does not detract from the critical need to foster a culture of independence and integrity from within, at any size of firm.

In pursuit of greater confidence in financial markets about the role of credit ratings, we will constantly monitor the risk of conflicts of interest in CRAs, including the risk of interference from commercial interests, which could reduce the independence and objectiveness of credit ratings. The 2013 sovereign rating process thematic investigation revealed areas of potential conflicts, such as the increasing role that published research, as a relevant revenue line, plays in the daily activity of a rating analyst, or the use by CRAs of external public relations agencies in some European countries which poses the potential risk of leakage of confidential data.

Defining and measuring the impact of ESMA's supervision is inevitably work in progress and there are no obvious metrics for doing so. As an indicator, however, in 2012 and 2013, ESMA required CRAs to implement six remedial action plans (consisting of some 110 individual actions), as a result of its findings from two thematic investigations. In parallel, several CRAs have significantly increased their compliance resources since July 2011 to deal with ESMA's supervisory interventions and the overall regulatory requirements. We see this as a first step forward in ensuring that the regulatory objectives are fully embedded in the CRAs' organisation and culture.

We see progress in how CRAs comply with the requirements of the Regulation. Examples of improvements made by one or more CRAs include:

- the strengthening of policies and practices, for instance with regard to better record keeping practices and more transparency in the area of preliminary rating activity;

- the empowerment of the compliance function, also through a stronger involvement of the CRAs' supervisory board, and its increasing independence, also thanks to growing size and seniority of the team; and

- the enhanced transparency and disclosure to the market regarding the credit rating activity, including more and clearer information on rating methodologies.

At the same time, there are areas where we identify the need for improvements (and which have been taken into account when drafting our supervision work plan), for instance with regard to:

- validation of rating methodologies, to ensure that a credit rating assessment is a comprehensive risk assessment and therefore leads to high quality ratings;

- internal governance, in order to ensure the full independence of the internal review function (from the analytical or commercial lines of business) and reduce the risk of potential conflict of interest; and

- robust IT systems supporting the rating process, including information security controls and protection of confidential rating information.

Therefore there is still much that can, and must, be done to restore market confidence in CRAs and the rating process. ESMA will continue to be an intrusive and proactive regulator, using our supervisory information and risk analysis capacity to determine the main risks which we must focus on, and committing annually to a challenging and ambitious programme of work.

2. EU CRA industry overview

2.1. The CRA market

The pool of registered CRAs in the EU is quite heterogeneous and is undergoing continuous change. There are currently 22 registered CRAs (at a group level), based in 11 EU member states. Among these, 10 CRAs have a domestic rating scope (in the sense that they issue only ratings on local entities), 10 have a global scope and 2 an EU scope.

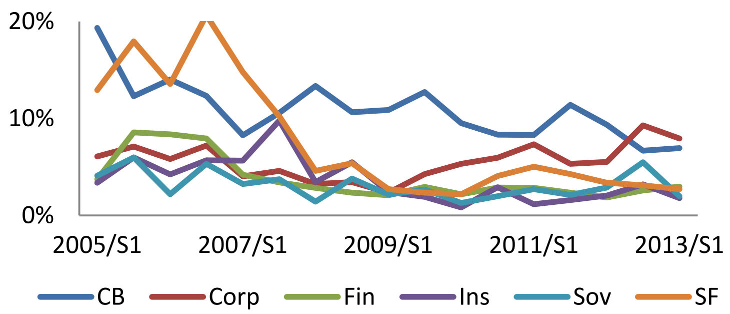
CRAs' market shares[2] differ significantly, with the majority of the market concentrated in the three large CRAs (Moody's, S&P and Fitch), whereas other small and medium-sized CRAs' market shares vary, though remaining below 5% for each individual firm. The majority of registered CRAs also provides a variety of ancillary services, which often constitute an important revenue source, particularly for some small and medium-sized CRAs. Ancillary services need to be carefully assessed in terms of potential conflicts of interests that may be posed to the rating activities. The list of registered CRAs, with an indication of their total market share and the types of credit ratings issued, was published by ESMA on its website on 16 December 2013 (see also section 3.3.2).

In terms of trends in rating activity, looking at the overall type and number of ratings assigned, we have not observed significant changes during 2013 compared to 2012. However, when considered in relative terms, certain small and medium-sized CRAs have increased substantially their number of outstanding ratings.

Expanding the observation period back to pre-financial crisis, it is interesting how issuance of new ratings (normalised by ratings outstanding in each category) has been uneven across different asset classes. For instance, while the sovereign ratings category has reported a relatively constant growth in the issuance of new ratings, issuance of new ratings in the non-financial corporate category has risen significantly, particularly over the past two years. On the other hand, ratings of financial products, such as structured finance and covered bonds, have reported a different trend. In the covered bond category, issuance of new ratings has been well sustained even after the financial crisis although at levels lower than those reported pre-financial crisis. For the structured finance category, while issuance of new ratings has grown rapidly until the beginning of the financial crisis, it has been in decline ever since. This is the result of reduced market activity on both the demand side (withdrawal of investors) and supply side (decline in origination of new assets available for securitisation).

[2] ESMA/2013/1933 (16 December 2013) – CRAs' market share calculation according to Article 8d of the CRA Regulation

Chart 1: number of new ratings as percentage of outstanding ratings



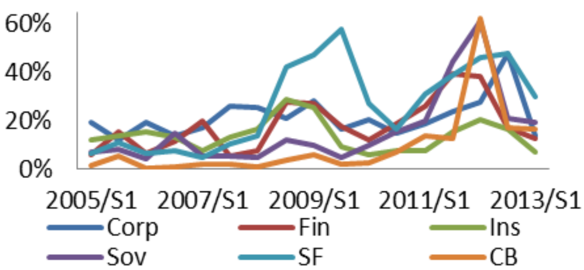
Note: CB refers to Covered bond, Corp to Corporate non-financials, Fin to Corporate Financial (excluding insurance), Ins to Insurance, Sov to Sovereign and SF to Structured finance
Sources: CEREP (limited to ratings where the issuance/issuer is located in the EU) and ESMA

Looking at the overall CRA industry turnover (generated by CRAs registered in the EU from credit rating activities and ancillary services[3]), there was around a 15% increase in 2012 compared to 2011. However, looking at the individual CRAs' data it emerges that the majority of CRAs have registered only a minor turnover change, within + or – 10%, with only few small and medium-sized CRAs increasing their turnover by more than 20%.

2.2. Downward shift of credit ratings in recent years

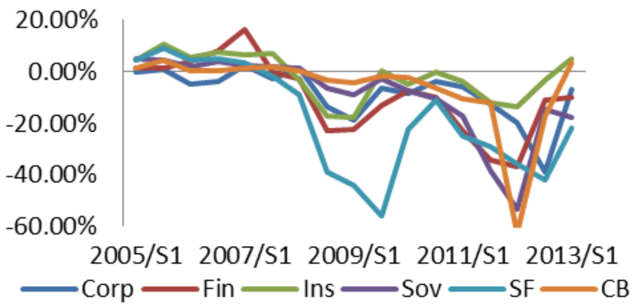
A credit rating is an assessment of the creditworthiness of an entity/issuer or an individual financial instrument/issuance. Amid the financial and, subsequent, sovereign debt crises the average rating of several classes of credit ratings deteriorated (with the exception of corporate ratings on insurance undertakings), although the magnitude of the decline varied between the different classes. Indicators are the increasing credit rating volatility (frequency of credit rating changes – chart 2) accompanied with negative credit rating drift (direction of credit rating changes – chart 3).

Chart 2: Notch-weighted volatility



Sources: CEREP (limited to ratings where the issuance/issuer is located in the EU) and ESMA

Chart 3: Notch-weighted drift

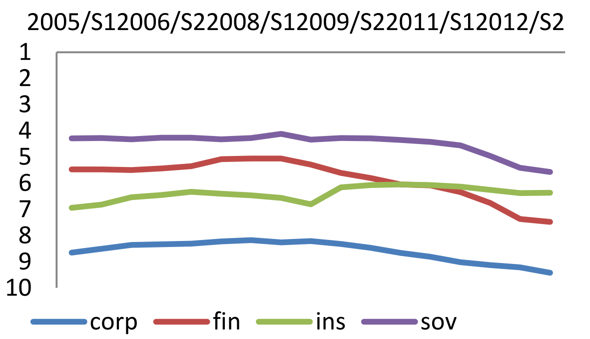


[3] Credit rating as referred to in Article 3(1)(a) of the Regulation. Ancillary services as referred to in point 4, Section B of Annex I of the Regulation.

Structured finance ratings experienced the most pronounced transition as they fell on average by more than 3 notches (from AA- to A-). Looking individually at the most common sub-asset classes which compose the structured finance category (i.e. RMBS, ABS, CMBS, CDO), they experienced a different degree of decline after 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 5). Currently, ratings of CMBS are on average below investment grade (nearly BB+) while those of CDO are just above (BBB-).

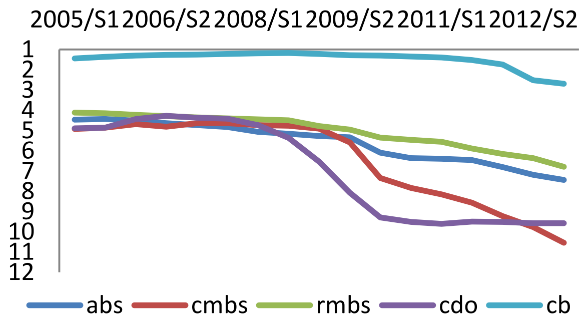
Credit ratings of financial institutions (excluding insurance) experienced a trend similar to that of the structured finance category as the average rating fell from A+ to A- (chart 4). Non-financial institutions and insurance companies present an interesting case as both asset classes had the tendency to be rated well below the others classes, although they experienced higher rating stability during the financial crisis (2008-2009) and subsequently the sovereign debt crisis (2010-2011). Covered bond ratings declined substantially in the recent period, however, they still maintain a prominent place relative to the other asset classes as the average rating was nearly AAA until early 2012, although decreasing to AA in 1st half 2013.

Chart 4: Average credit rating - issuer ratings



LHS in terms of notches using 21 notch scale (1=AAA, 10=BBB-)
Sources: CEREP (limited to ratings where the issuance/issuer is located in the EU) and ESMA

Chart 5: Average credit rating - issue ratings



3. 2012 Annual Report commitments and 2013 deliverables

3.1. Registration gateway

Registration and certification are core activities within ESMA's supervisory responsibilities. The assessment process for obtaining registered status is rigorous and demanding. For ESMA, it is vitally important that the gateway to registered status is guarded diligently and applicants are granted registration only if they demonstrate their ability to meet all the regulatory requirements. Registered status should not be regarded as an endorsement by ESMA of the subsequent ratings activity. Not only should the initial requirements for registration be considered, but the reporting and on-going compliance obligations that follow once a CRA has succeeded in being registered should be taken into account by prospective applicants.

Any firm that is established in the EU and is carrying out credit rating activities in the EU without prior registration is operating in breach of Articles 2(1) and 14(1) of the Regulation. Action, leading to supervisory measures and fines, will be systematically taken by ESMA against firms that conduct credit rating activities without registration or, where appropriate, certification in the EU. Therefore, any firm planning to issue ratings should immediately apply to ESMA for registration.

There will usually be considerable interaction between an applicant and ESMA during the registration process. While ESMA's case handlers are available to offer as much practical feedback as possible, at the same time, it is not ESMA's role to provide advice to applicants, to act as a consultant or to remedy deficiencies in the application. Any assistance is therefore limited to making an applicant aware of more general guidance documents approved by ESMA, such as guidelines and recommendations on the scope of the Regulation (published in June 2013[4]) or the Q&As on the implementation of the Regulation (published in December 2013[5]), or to clarify issues raised by a potential applicant. In all cases the onus remains on the applicant to satisfy ESMA that the regulatory requirements are met.

The registration process focuses on the same priority areas as the overall Regulation, namely the rigour, quality and testing of the rating methodologies, the independence of the rating process, the proper disclosure of methodologies and ratings, procedures in place to control conflicts of interest, and sound corporate governance, internal control and organisational arrangements. Following the amendments to the Regulation which came into force in June 2013[6], additional provisions were put in place affecting the registration process such as the new requirements on the disclosure of conflicts of interest by shareholders and the publication of an annual calendar for sovereign ratings.

[4] ESMA/2013/720 (17 June 2013) – Final Report: Guidelines and Recommendations on the scope of the CRA Regulation

[5] ESMA/2013/1935 (17 December 2013) – Questions and Answers: implementation of the Regulation (EU) No 462/2013 on Credit Rating Agencies

[6] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (the Regulation).

There were 22 registered CRAs on a group basis and two certified CRAs at the end of 2013.

During 2013, ESMA assessed and approved the registration of three new CRAs: The Economist Intelligence Unit Ltd, based in the UK, Dagong Europe Credit Rating Srl, based in Italy, and Spread Research, based in France, and certified one US-based CRA, Kroll. Two further applications went through the full assessment process but were rejected by the Board of Supervisors, whilst three more were withdrawn during the registration phase. Four more applications are currently being assessed and a number of other potential applicants have informed ESMA of their plans.

In comparison to 2012, when only one applicant was assessed by ESMA directly, registration activities have increased substantially in 2013. Considering the interest shown by potential applicants, we do not foresee any reduction in the registration activity in the near future.

Where applications have been rejected by the Board of Supervisors, we have noted a number of common areas where the applicants have had difficulty in demonstrating compliance with the regulatory requirements.

Examples of such areas of common difficulty include:

- a failure to demonstrate the independence and accuracy of the credit ratings, and that the issuing of the ratings would not be affected by conflicts of interest;
- the absence of adequate policies and procedures, or clear and documented decision-making processes;
- inadequate governance controls and poorly defined roles and responsibilities for senior executives;
- the absence of sound internal control mechanisms capable of identifying and managing conflicts of interest;
- the concentration of design, oversight and implementation of key policies and procedures in a single individual;
- a failure to demonstrate the independence of the review function;
- insufficiently robust and systematic methodologies and failure to ensure that methodologies are properly and regularly monitored and validated; and
- inadequate IT and information security systems.

Outsourcing is an equally challenging area for new applicants. The Regulation recognises limits to outsourcing key operational functions if that results in materially impairing the effectiveness of internal controls and the ability for ESMA to exercise its supervisory mission. Yet we have encountered proposals for important analytical functions to be carried out in non-equivalent countries (thus presenting a barrier to ESMA's direct supervision) or for analytical staff to be sub-contracted from an associated company. In the latter case, the contract would be on a short-term basis and would jeopardise the ability of the analyst to continuously monitor a rating as well as present potential conflicts of interest depending on the nature of their other responsibilities.

Some of the common difficulties encountered by applicants were also examined in a recent appeal against a decision by ESMA's Board of Supervisors not to register a CRA[7], where the reasons given in the refusal decision were challenged by the appellant (as part of its grounds for the appeal).

New applicants will generally request one or several of the available exemptions from certain aspects of the Regulation. Until the entry into force of the amended Regulation in June 2013, exemptions were permitted for the need to have independent directors, a compliance function and rotation. Under the amended Regulation, an exemption from having a review function may also be requested.

However, what we see frequently are applicants failing to consider that an exemption will only be granted if they can demonstrate they have implemented measures and procedures which guarantee compliance with the same objectives as the requirements they wish to be exempted from.

ESMA is often asked if it has any preference for specific business models, governance frameworks or threshold numbers of staff. We do not have any preconceptions, although some choices are likely to raise more challenges than others. For example, very low numbers of staff will make it hard to demonstrate that robust and independent governance structures and control functions have been put in place. Where staff engaged in ratings activities are employed on a part-time basis, or outsourced, the ability to meet the requirements for the continuous monitoring of ratings may be compromised. As referred to above, concentrating activities which might present conflicts of interest in a single individual is also problematic. However, it is for the applicant to demonstrate that it is able to ensure compliance with the Regulation, regardless of the approach followed.

3.2. Supervision

The 2012 Annual Report concluded with the statement that CRAs should continue the vital process of fully embedding the main requirements of the Regulation into their organisations and that further improvements were necessary in the following areas:

- consistent application and comprehensive presentation of rating methodologies;
- empowerment and resourcing of analytical and control functions;

[7] BoA 2013/14 (10 January 2014) – The Board of Appeal's decision in an appeal by GPRC against a decision of ESMA

- monitoring and surveillance of ratings; and
- reliability of IT infrastructures.

We stated that our supervisory activity in 2013 would focus on these matters; we also noted ESMA's regulatory obligation to *verify* all registered CRAs by July 2014.

In 2013, we dealt with these areas of activity in a number of different ways, principally through thematic work, and, in the case of the verification exercise, individual investigations into 14 small and medium-sized CRAs.

Each of these activities is described in the following section.

3.2.1. How we have made a difference

Bank rating methodology thematic investigation

This substantial thematic investigation took place in 2012 and was reported on in detail in the 2012 Annual Report, published in March 2013[8]. The remedial action plans for each CRA were, however, set in place in the first quarter of 2013 and monitored through the year as part of on-going supervision.

As a result of the remedial plans, one or more CRAs have taken action in the following areas:

- developed more rigorous policies and procedures to demonstrate adherence with the requirements of the Regulation when methodologies, models and key rating assumptions change – with particular reference to how the affected ratings are disclosed, and the requirements to place the ratings under observation and to carry out an internal review of any of the ratings which have been affected (Article 8(6) of the Regulation);
- established new processes for ensuring the quality of the information used in the issuance and on-going monitoring of ratings;
- codified the analytical criteria, guidance and instruments which formed part of the existing practices for bank rating methodologies, and taken steps to ensure the necessary disclosure to both the public and ESMA (Article 11 and Section E of Annex 1 of the Regulation);
- updated their methodologies, to include details on the qualitative and quantitative factors used within the methodology (Articles 4.2 and 4.3(a) of the Commission Delegated Regulation (EU) No 447/2012);

[8] ESMA/2013/308 (18 March 2013) – Credit Rating Agencies Annual Report 2012

- installed new links to their websites so that users can have easy access to historic versions of rating methodologies which are of relevance to them;

- improved record-keeping and review mechanisms relating to the technical details of models and analytical tools;

- enhanced internal peer review practices; and

- amended rating committee policies and procedures so that, where a particular factor in a rating is not reassessed at the time of a rating action, this fact, and the justification, are clearly documented.

Sovereign rating process thematic investigation

We announced last year that we would carry out a thematic investigation into the sovereign rating process of a number of CRAs. During a two-month period in the Summer of 2013, we conducted over 60 onsite interviews at the three largest CRAs to assess the governance, conflicts of interests, resourcing adequacy and confidentiality controls associated with the sovereign rating process. This followed an in-depth desk-based evaluation of information on each of these areas.

In a number of areas associated with conflicts of interest and independence, we have concerns that the actual failings or potential risks identified might compromise the independence of the ratings process and the quality of the credit ratings. These included:

- senior management involvement in sovereign rating activities;

- the independent review function's participation in the sovereign rating process;

- revenue generating research publication activities carried out by CRAs;

- the involvement by certain non-rating functions (e.g. communication) in the rating process; and

- how the appeal procedure worked in practice[9].

The investigation identified deficiencies in the way confidential rating information is managed, in particular how access to information on upcoming rating actions on sovereigns is controlled. These include:

- the disclosure of upcoming rating actions to an authorised third party;

[9] Through the (external) appeal procedure rated entities can ask a CRA to reconsider a rating decision before its publication, and provide new information which may be relevant for the rating decision.

- inadequate controls in place for the circulation of rating information within the CRA;

- the use of external communication consultants; and

- inappropriate permissions and controls for securing access to rating information.

Disclosure was another area of concern. We found that there had been instances of significant and frequent delays in the publication of sovereign ratings. We also observed deficiencies in the advance notification to rated entities about upcoming rating actions and in the time allocated to the rating committee preparation to allow attendees to adequately prepare for the meeting.

With reference to the resources allocated to sovereign ratings, we had concerns about the appropriateness of mechanisms to assess the adequacy of resources, the allocation in certain cases of lead analyst responsibilities to junior or newly hired staff and unclear definitions of functions and responsibilities.

We were however encouraged in noting a number of good practices amongst the examined firms, including dedicated training programmes for analytical staff, enhanced challenge in rating committees, and consistency and continuity in the allocation of analysts to sovereign portfolios.

Following the onsite visits and the assessment of the findings, individual remedial action plans have been set for each of the CRAs investigated, with the majority given deadlines for implementation by the end of December 2013, or by latest the end of March 2014.

INEDs[10] are expected to take an active role in the oversight of the implementation of the action plans.

ESMA published a report on the Sovereign ratings investigation on 2 December 2013[11].

Thematic investigation into the monitoring of structured finance ratings at four large CRAs

Last year we also announced our plan to carry out specific supervisory work on structured finance ratings. This thematic investigation is on-going and focuses on the Residential Mortgage Backed Securities (RMBS) asset class (which is the most representative of the overall structured finance instruments market), through a selected sample of EU RMBS transactions, and will cover the organisation and processes of the structured finance monitoring function. This will entail looking at:

- the workflow and organisation of monitoring teams;

- fee setting policies and procedures;

[10] The Regulation requires at least one third and no less than two members of an administrative or supervisory board to be independent. They should not be involved in credit rating activities nor should their compensation be linked to the business performance of the rating agency.

[11] ESMA/2013/1775 (2 December 2013) – ESMA's Report on CRA sovereign ratings investigation

- data availability and reliability (including data quality controls carried out at the level of underlying financial instruments);

- automated surveillance tools and analysis conducted by monitoring teams through the implementation of rating methodologies and models; and

- the specific disclosures in structured finance rating announcements, along with their associated controls.

We said at the time that our decision to focus on this area of activity was driven by the high levels of outstanding volumes of structured finance products in the market – notwithstanding the sharp drop in new issuance after the financial crisis – and the very high levels of rating transitions and defaults.

Investigation into the ratings publication controls in a single CRA

During 2011 ESMA completed its first general investigation of the major registered CRAs. The report, published in March 2012[12], revealed that IT risk was generally high across the firms reviewed. In 2013, therefore, we carried out an assessment of the controls surrounding the publication of credit ratings on the website of one particular CRA with a view to analysing the cause of recurrent delays in updating the information on the ratings.

The overall objective was to acquire a good understanding of the CRA's credit rating dissemination process and the supporting IT environment in order to assess how it complied with the requirements of the Regulation. As part of the review, on-site inspections took place in June/July 2013.

The investigation focused on the following aspects of the ratings publication and dissemination process: i) the process for ensuring the timely disclosure of the ratings, ii) the underlying IT infrastructure (applications, databases, data flows) and iii) the decision-making procedures, and the organisation of the departments involved, as well as the supporting documentation.

We identified a number of issues which are of relevance to all registered CRAs:

- it is vital that the presentation of changes to ratings on websites (and any other tool used to communicate them, such as data-feeds) is fully transparent, and that those changes are communicated in a timely way. This also requires regular monitoring of the content of the website to ensure that the information related to credit ratings is always up-to-date;

- the IT architecture and related control mechanisms supporting the publication and dissemination of ratings should be adequate to ensure the timely disclosure of credit ratings and the continuity and regularity of the credit rating activity;

[12] ESMA/2012/207 (22 March 2012) – ESMA's report on the Supervision of Credit Rating Agencies

- there should be monitoring tools in place to track, log and review essential activities in the dissemination process; and

- there should be a clear allocation of responsibilities and formalised, fully documented, procedures for the way ratings related information is processed.

Small and medium-sized CRA investigation

During 2013 we conducted a general investigation into 14 smaller and medium-sized CRAs in accordance to the Regulation's requirements (Article 40a(6)) as well as ESMA's 2013 supervisory work plan (ESMA/2013/87). The investigation focused on the main identified areas of regulatory risk such as the arrangements, including systems and controls, put in place by the CRAs in order to be compliant with the Regulation as well as their business strategy.

The investigation included a combination of desk-based assessments and targeted on-site inspections. The desk-based assessments focused on the answers to a supervisory questionnaire sent to the CRAs in March 2013. Following this assessment, we conducted on-site inspections which consisted of interviews with the CRAs' key employees, such as Board members (including the independent members, if applicable), the CEO/President/Managing Director, the Heads of compliance, internal review and internal audit functions (if applicable) and persons participating in the credit rating activities. In particular, we looked at:

- the role of the independent members of Administrative or Supervisory Boards, and the extent to which they understood and discharged their roles and responsibilities under the Regulation;

- the independence and resourcing of the compliance function, and its effectiveness in terms of monitoring conflicts of interest;

- the clarity of reporting lines for the compliance function, and the adequacy of its reporting to the board;

- the independence of the internal review function and whether validation procedures were properly conducted;

- appropriate disclosure of methodologies and changes to these;

- resourcing, and whether this was adequate to ensure continuity and regularity in carrying out credit rating activities; and

- where exemptions had been granted, the degree to which the CRA had alternative controls and arrangements in place to comply with the Regulation in the absence of a particular function.

By 1 July 2014 ESMA will have finalised its investigation on the remaining smaller and medium-sized CRAs which had registered status on 31 December 2013.

On-going supervision

In the previous sections we described the principal outcomes of specific thematic or individual investigations. We used regular and on-going supervision to follow-up on completed investigations, including monitoring the implementation of the defined remedial actions. Through on-going supervision we also tackled a number of issues which could have compliance implications, including:

- the endorsement of credit ratings issued in third countries, in relation to CRAs which either already endorse credit ratings or intend to do so;
- the assessment of the new procedures and governance controls put in place by CRAs; and
- the consistent application of the requirement to notify issuers.

More generally, together with the fundamental responsibility of ensuring CRAs' compliance with the requirement to have ratings which are independent, objective and of adequate quality, we put particular emphasis on the issue of potential conflicts of interest arising from the CRAs' business activities and organisational structure. For instance:

- we looked into the contracts in place between one or more CRAs and the issuer and identified that in some cases, there were provisions which might give rise to conflicts of interest or disclosure issues; therefore we asked the CRA to revise the contracts to address these points;
- we looked at the measures one or more CRAs had in place to identify the potential conflicts presented by the affiliation of their board members to rated entities or issuers. In some instances changes were implemented to strengthen the effectiveness of the existing conflicts of interest's controls.

3.2.2. Enforcement

As part of its supervisory duties, ESMA also assesses whether there are possible facts liable to constitute an infringement (as set out in the Regulation), in which case an Independent Investigating Officer (IIO) shall be appointed within ESMA to investigate the matter (Article 23e of the Regulation). Such an appointment was made in one instance in 2013. This follows another appointment made in 2012.

3.2.3. Transparency

Accountability is one of the six characteristics that drive ESMA's work. In line with this characteristic, in our 2012 supervisory annual plan we committed to increasing the transparency of our regulatory activities. We also committed to enhancing the communication of our supervisory criteria with the aim of levelling the playing field and/or raising the bar for all industry players.

Publications

ESMA typically shares its findings and concerns with all supervised entities and its other stakeholders where thematic or investigative work has highlighted broader issues relevant to several supervised entities. As we have mentioned in a previous section, in December 2013, we published a report on our findings following the thematic investigation that we conducted on the sovereign rating processes. The report described the deficiencies but also good practices identified in the course of that investigation regarding the independence and avoidance of conflicts of interests; confidentiality of sovereign rating information; timing of publication of rating actions; and resources allocated to sovereign ratings. We requested CRAs to implement remedial actions in order to address the identified deficiencies.

Regular communications with supervised entities

Although public reports are a useful tool for ESMA to communicate its views on how far CRAs meet the regulatory requirements, ESMA also engages with the industry using non-public means of communication when it receives specific individual questions. For instance, in the past year ESMA wrote to all registered CRAs before the entry into force of the amended Regulation explaining a number of operational issues associated with the regulatory changes.

Industry roundtables

ESMA has arranged three roundtables with the industry since it took on its supervisory powers in July 2011. These meetings have proved to be an additional efficient communication channel for ESMA to express its concerns to the industry and convey messages about how it expects the industry to meet the regulatory requirements. Answers to the questions raised by the industry during the latest roundtable were published in December 2013 as part of the Q&As previously referred to in this report.

Cooperation and engagement with other stakeholders

Cooperation with National Competent Authorities (NCAs) and third country regulators is an important factor in facilitating ESMA's effective supervision of CRAs.

NCAs have referred information to ESMA regarding the activities of CRAs in the local financial markets which has been used in the relevant reviews or in other supervisory follow-up.

ESMA has continued to exchange supervisory information on a periodic basis with several third country regulators in the course of 2013. The cooperation with third country regulators has been reinforced in 2013 with the establishment of supervisory colleges, which met for the first time in November 2013. The supervisory colleges aim to promote information-sharing and cooperation in order to enhance risk assessment of the three largest internationally active CRAs and to support effective supervision of these CRAs. The authorities responsible for the supervision of

CRAs in seven[13] different jurisdictions have formed the basis of the first core colleges, which are chaired by ESMA (Fitch) and the SEC (Moody's and Standard & Poor's).

ESMA has also engaged with market participants more broadly through delivering presentations and speeches at numerous seminars and conferences. These constitute informal fora where ESMA gathers information regarding potential risks and deficiencies to be investigated. They also provide ESMA with the opportunity to present its views and explain its supervision to all market players.

In 2014, ESMA would like to enhance its engagement with investors and issuers and is currently exploring ways to increase its visibility and facilitate market participant contact with ESMA. For this purpose, ESMA is in the process of redeveloping the CRA section of its webpage.

Complaints

ESMA engages with various stakeholders when dealing with complaints, for example industry associations, individual issuers (e.g. financial institutions), national and sectoral competent authorities, members of the European Parliament and registered CRAs. Although we may not react with a particular supervisory action to each complaint filed or information referred to us, all information brought to ESMA's attention is taken into consideration for risk identification purposes and potential follow-up action.

Examples of the issues market participants have brought to the attention of ESMA include potential failures to comply with the requirements regarding the presentation of credit ratings, systematic application of methodologies, and consultation on changes to methodologies.

The number of complaints that ESMA receives annually remains limited.

3.2.4. Other tools supporting transparency and supervision

ESMA has set up two IT platforms for the collection of standardised rating information from CRAs. The two platforms were created as a result of the requirements under Regulation (EC) No 1060/2009 which mandate CRAs: i) to make available in a central repository established by ESMA (CEREP) information on their historical performance data[14]; and ii) to provide ESMA with periodic reporting on rating actions data (SOCRAT).

While data provided to SOCRAT is used for the purpose of on-going supervision[15] and remains confidential to ESMA, information communicated to CEREP is publicly available.

[13] Australian Securities & Investments Commission (Australia), Comissão de Valores Mobiliários (Brazil), European Securities and Markets Authority (Europe), Financial Services Agency (Japan), Comisión Nacional Bancaria y de Valores (Mexico), Ontario Securities Commission (Ontario, Canada), Securities and Exchange Commission (U.S.)
[14] Article 11(2) and point 1 of Part II of Section E of Annex I of Regulation (EC) No 1060/2009
[15] Point(e) of article 21(4) of Regulation (EC) No 1060/2009

By the end of 2013, both systems had been in place for more than one year and contained data covering more than 12 years in the case of CEREP and more than one year of individual rating actions data in SOCRAT.

The main purpose of CEREP is to calculate the CRAs' performance statistics which are then made available to the public on the relevant website http://cerep.esma.europa.eu/cerep-web/.

Based on the most recent usage statistics, there is an average of around 3,000 users per month. Most of the CEREP page visits are from Europe (50% with most of those from France, UK, Italy and Germany), China (c. 18%), followed by United States (c. 11%) and Russia (c. 9%).

The CEREP public database was improved during 2013 with the integration of a new filter for selecting the EU-related ratings and also by the addition of new information on defaulted instruments in the form of matrices that display the credit rating at the beginning of the statistical period of choice and the rating prior to the default.

The CEREP database was also enhanced in 2013 to capture rating data for (non-structured) covered bonds in addition to the corporate (financials, insurance and non-financials), sovereign and structured finance rating data already captured. The CEREP statistics are accordingly more comprehensive and more aligned to the SOCRAT data (which already includes the covered bonds rating data).

The CEREP data reported by CRAs feeds into market analyses and is used for a number of internal purposes as well as for technical advice offered to the other European Supervisory Authorities (ESAs). It was an important source of data for the latest technical advice given to the European Commission (EC) in October 2013 for its assessment into the feasibility of a network of small and medium-sized CRAs. For this purpose, ESMA provided quantitative and qualitative information on the relevant CRAs derived from CEREP data. CEREP data were also shared with the European Banking Authority (EBA) for the mapping of the credit categories of External Credit Assessment Institutions (ECAI).

With reference to SOCRAT, following its launch in November 2012, we have worked on improving the consistency and usability of data as it becomes an increasingly important source of information for on-going supervision and thematic investigations. Although historical data is still limited and thus the information is currently used mainly to assess the present situation, in time, it will become a progressively more valuable tool for analysing sector trends.

3.3. Policy

3.3.1. Guidelines and Recommendations on the scope of the Regulation

On 17 June 2013, ESMA published Guidelines, aimed not only at market players but also at national competent authorities, with the purpose of providing clarification on the scope of the Regulation. In particular, clarifications regarded the provisions on:

- the obligation to register;

- the credit rating activities falling within the scope of the Regulation and exemptions from registration;
- the status of private ratings; and
- whether branches established in third countries are covered by the Regulation.

The Guidelines also included specific disclosure recommendations for credit scoring firms and CRAs established in third countries and provided information on enforcement of the scope of the Regulation and cooperation with competent authorities.

3.3.2. CRA3 implementation

Draft Regulatory Technical Standards

During the first quarter of 2013, ESMA continued to provide technical support to the EC, the European Parliament, and the Council during the negotiation of the CRA3 legislative package. After the publication on 31 May 2013 of CRA3[16], ESMA published its discussion paper on CRA3 implementation[17] on 10 July 2013 in order to gather information from stakeholders on the three draft Regulatory Technical Standards (RTS) ESMA must submit to the EC by 21 June 2014 (information on structured finance instruments; the new European Rating Platform; and the periodic reporting on fees charged by credit rating agencies). Follow-up activities included a public hearing ESMA organised on 25 July 2013 to solicit views from stakeholders.

Q&As on CRA3 implementation

On 17 December 2013, ESMA published Q&As on the implementation of CRA3. The objective was to provide clarity on the application of the new requirements starting from the questions posed by credit rating agencies and market participants in relation to the practical application of CRA3.

Publication of the list of registered CRAs indicating their total market share

Article 8d of the Regulation requires ESMA to publish annually on its website a list of registered CRAs, indicating their total market share and the types of credit ratings issued. The same article 8d also requires issuers or related third parties to document when they decide not to appoint at least one CRA with no more than 10% of the total market share. The objective of ESMA's list is therefore to facilitate the evaluation of issuers or related third parties should they intend to appoint more than one CRA for the credit rating of the same issuance or entity.

On 16 December 2013, ESMA published the list of registered CRAs indicating their total market share for the 2012 calendar year (reference to ESMA's publication available at page 6, footnote 2).

[16] Regulation (EU) No 462/2013 (CRA3) and Directive 2013/14/EU
[17] ESMA/2013/891 (10 July 2013) – Discussion Paper on CRA3 implementation

Technical advice on the feasibility of a network of small and medium-sized CRAs

CRA3 requires that ESMA shall submit a number of technical advice documents to the EC in the course of the next few years. On 21 November 2013, ESMA published the first piece of such technical advice concerning the feasibility of a network of smaller CRAs[18]. The objective of the advice was to provide information concerning the activity of small and medium-sized CRAs, and possible barriers to entry for companies that wish to conduct rating activities in the EU. It included quantitative and qualitative information based on the data gathered through the periodic public reporting obligations of CRAs to ESMA.

3.3.3. Cooperation with international authorities and organisations

International developments (IOSCO)

In addition to the enhancement of the on-going dialogue with third-country authorities at the International Organization of Securities Commissions (IOSCO) Committee 6, ESMA contributed to the drafting of the recommendations for Supervisory Colleges for CRAs (published on 30 July 2013 on IOSCO's website[19]) - which recommended establishing supervisory colleges for internationally active CRAs and provided preliminary guidelines on the colleges' functioning (see also section 3.2.3). ESMA also contributed to IOSCO's report to the Financial Stability Board (FSB) regarding transparency and competition among CRAs, and to the current revision of the IOSCO Code of Conduct for CRAs.

Over-reliance on credit ratings

During 2013 the ESAs accomplished a joint project aiming at the removal of references to credit ratings in their guidelines and recommendations which could result in market participants' sole and mechanistic reliance on such ratings.

The final text of the Guidelines has been published on 6 February 2014[20].

Mapping of CRAs

As demanded by Article 136 of Regulation (EU) No 575/2013 (CRR Regulation), ESMA co-operated with EBA over the course of 2013 on the development of draft Implementing Technical Standards (ITS) to specify the correspondence between the credit quality steps (CQS) and the credit ratings categories of registered and certified CRAs (mapping). EBA, EIOPA and ESMA are required to submit their draft ITS to the EC by 1 July 2014.

[18] ESMA/2013/1703 (21 November 2013) – Technical Advice on the feasibility of a network of small and medium-sized CRAs
[19] (IOSCO)FR08/13 (30 July 2013) – IOSCO's Final Report on Supervisory Colleges for Credit Rating Agencies
[20] JC/2014/04 (6 February 2014) – EBA, EIOPA and ESMA Final Report on mechanistic references to credit ratings in the ESAs' guidelines and recommendations

3.3.4. Equivalence

During 2013 ESMA published technical advice in respect of the equivalence between the EU regulatory regime for CRAs and the respective legal and supervisory frameworks of Argentina, Brazil, Mexico, Hong Kong and Singapore[21].

[21] ESMA/2013/626 (30 May 2013) – Final report: technical advice on CRA regulatory equivalence on Argentina, Brazil, Mexico, Hong Kong and Singapore

4. CRA supervision work plan for 2014 and beyond

The CRA supervision work plan takes into account the lessons we have learnt from our supervisory activity since 2011 as well as what type of supervision we want to deliver.

Since we adopt a risk-based approach to supervision, the work plan is also driven by the outcome and findings of our risk-analysis activity. We use our risk-analysis framework to assess trends and risks at both industry and individual CRA's levels, with a focus on environmental, operational, business model, and governance risks (more details on our risk model in section 4.3).

A key lesson learnt so far is that a combination of on-going supervision and specific supervisory projects has proved to be effective in both ensuring compliance and risk prevention. Firstly, when drafting the supervision work plan we have to take into account that some of our on-going supervisory activities are simply necessary to be done in order to verify that "the house is kept in order" and to assess CRAs' compliance with the new and evolving Regulation. Secondly, we recognise the importance of having processes in place which allow a better understanding as well as an early identification and management of risks, for instance through a dedicated risk function and focused cross-firm supervisory projects, with a specific scope and clear objectives. Undertaking individual risk-based projects has also proved to be invaluable in enhancing our knowledge of the CRA industry and individual firms and thus making an immediate impact on specific areas of concern within the credit rating industry, while also positively influencing our on-going supervisory activity.

Another lesson learnt is that being ambitious and setting challenging targets is the right approach to quickly learn about the industry and build up a reputation as a proactive and preventive supervisor, able not only to verify that "the house is in order" but also drive positive changes in the CRA industry. At the same time targets need to be achievable, and the last two years have also shown the importance of reserve capacity for newly emerging risks or priorities or in cases where planned/on-going activities require more extensive work than initially envisaged.

While we strive for transparency in communicating our work plan it needs to be acknowledged that a proactive and risk-based supervisory approach also requires flexibility and the ability to act and react according to new information and changed circumstances.

4.1. Supervision investigations

4.1.1. Thematic investigation

As explained previously in this report, the on-going thematic investigation on structured finance is one of our key deliverables for 2014. The underlying rationale has been explained both in last year's report and previously in this report.

A second key deliverable will be an in-depth thematic investigation into how CRAs review and validate their rating methodologies, with particular reference to the use of historical experience, including back-testing.

While the project can be considered mainly as an investigation aimed at enhancing our understanding of the current industry status and individual CRAs' practices with regards to review and validation of their methodologies, our ultimate target is to raise standards by clarifying what ESMA expects from CRAs, what it considers to be best practice, and by communicating these to the industry. In our opinion this has the potential to enhance the effectiveness of CRAs' internal review function and the quality of assigned ratings.

The decision to undertake such a review is based on a number of drivers, which have either a regulatory or risk rationale:

- Capital Requirement Directive IV and the possible use of ECAIs' credit ratings for capital purposes increases the detrimental impact on investors and the financial system of low quality ratings. The risk of having low quality ratings is increased by weak validation procedures;

- Art 8.3 and 22a of the Regulation both emphasise the relevance of validating the CRAs' rating methodologies and ESMA's responsibility in that regard;

- the observation of the historical performance by individual rating classes shows highly irregular patterns (especially for the rating classes of financial corporates and structured finance products). This is usually coupled with high ratings volatility, more marked in a contracting economic environment, where it is not unusual to observe rating actions resulting in downgrades of multiple notches. While those observations are indicative of potential risks stemming from several areas of the CRAs' rating activities (for instance, volatile performance as well as substantial rating changes may be the result of inflated ratings at their initial assignment), we have concerns that weak monitoring of ratings over their life and/or inadequate review of methodologies and their validation could also be key drivers; and

- lack of sufficient evidence of appropriate and embedded validation processes (including back-testing). Overall, one of the most common tools used in the validation process is the default and transition matrix. However, we have concerns about its adequacy as a single tool for validation, in particular when the CRAs have numerous and highly complex methodologies in place.

4.1.2. Small and medium-sized CRA investigation

During 2013 we conducted a horizontal investigation of 14 small and medium-sized CRAs (described in the section 3.2.1). We plan to complete the verification on the other small and medium-sized CRAs which were registered either at the end of 2012 or during 2013 and therefore not included within the scope of the 2013 investigation mentioned above.

The structure and the focus of the review will replicate that of last year - which proved to be effective in identifying the areas of major concern and addressing relevant issues. Similarly to last year, particular attention will be given to the internal control function, including compliance, and business strategy (often heavily dependent on certain revenue sources) which are the areas where we see the major risks for the small and medium-sized CRAs in relation to being able to meet the regulatory requirements in terms of quality of ratings, conflicts of interest and good internal governance.

4.1.3. Individual investigations

During our on-going supervisory activity and as a result of the ad-hoc investigations we have conducted so far, we have identified issues specific to individual CRAs where we plan to undertake further dedicated work. While we use our on-going supervision to deal with many of them, we also view an individual investigation as the right tool where we identify a risk of potentially major harm or non-compliance. In those situations, dedicated attention and effort is expected to have the greatest impact on reducing the risk.

Specifically, during 2014 we plan to undertake individual investigations on the rating process (with focus on key elements of the rating process which could have a significant impact on the quality of the ratings), and IT systems and controls (with particular focus on information security).

Regarding the review on the rating processes, we also plan to look at the impact that CRAs' business decisions might have on the rating activities. While business-related decisions are in the remit of individual CRAs, we have concerns that, in the absence of appropriate controls, some could pose risks to the ability of the CRA to ensure the continuity of its rating activities, the independence of the decision-making process and to maintain the confidentiality of rating information.

IT and information security represent also areas of increasing concern, in particular for large CRAs for which the complexity and large scale of the rating activities need to be accompanied by an appropriate IT and information security structure. An inadequate IT framework with poor security and access controls, fragmented governance and frequent errors may lead to important deficiencies in the CRA's activity, for example in terms of confidentiality, disclosure of information to the public and quality of the data used in the rating analyses. In particular, weaknesses have been identified in several CRAs in the field of IT-related processes and controls although specific issues vary by CRA. For that reason, IT is likely to be an area which we will keep monitoring across CRAs going forward.

Since the aforementioned issues emerge in several CRAs, we expect to use the outcome of the individual investigations to inform the supervisory actions on other CRAs, where applicable.

4.2. On-going supervision

Our on-going supervision activities are inevitably both proactive and reactive. They are influenced by the knowledge and experience gained since ESMA's inception as a result of the regular assessment of periodic information, meetings with key people in CRAs, new areas of concerns identified through our investigations, or new risk arising from our market trend analysis.

By their very nature, on-going supervision activities cannot be fully planned in advance, and we believe that amongst the best qualities of a supervisor are: flexibility, the ability to adapt to new priorities and respond to them. This is the type of supervision that ESMA is practicing.

While we recognise that new priorities might emerge during 2014 and change our agenda, nevertheless we have identified some areas our on-going supervision will be focusing on during the year, a summary of which follows:

- the implementation of the remedial action plans following the completion of our thematic investigations (e.g. banking, sovereign), first verification on small and medium-sized CRAs, ad-hoc or individual reviews. The on-going supervisory plan at individual CRA level is also adjusted in order to address specific risks we have identified for each CRA (e.g. IT and internal control functions, including compliance). After completion of the structured finance thematic investigation, it is also likely that a new set of activities will be included in the on-going supervisory plan to ensure that we again follow up on the implementation of the remedial action plans from that thematic review; and

- specific assessment on CRAs' compliance with the new requirements of the CRA3 Regulation (particular focus will be put on pricing policies and procedures and the disclosure aspects of sovereign ratings, including those ratings issued in third countries and endorsed).

Furthermore, ESMA has an active role within IOSCO's college of supervisors of CRAs, where it also chairs the college for Fitch.

4.3. Enhancement of risk analysis framework

We are developing and enhancing our CRA related risk analysis function. The objective is to create a framework which is able not only to identify the industry trends and major risks, but also to challenge and influence our supervisory strategy on an on-going basis aiming at strengthening our risk-based approach to supervision.

Our risk framework, including the core risk analysis model, consists both of stand-alone analytical activities (e.g. market intelligence, data analysis) and increasing interaction and coordination with the supervisory function (e.g. risk impact analysis of supervisory activities).

Our core risk analysis model is developed around the following two pillars:

- CRA impact, expressed in terms of damage to the stability of the financial system or investor protection caused by potential breaches of the Regulation. This is calculated for each CRA on the basis of a pre-defined set of factors and weightings; and

- event probability, expressed in terms of likelihood of regulatory failures and infringements. This is calculated based on four main risk categories (environmental risk, operational risk, business model risk, and governance risk) and related sub-categories (13 in total). It is determined through individual supervisory judgement based on a pre-defined set of criteria to ensure consistency and comparability.

The outcome of the risk analysis model feeds into the preparation and the implementation of the annual supervision work plan.

Amongst the activities the risk function plans to undertake is also the on-going analysis of the business models of the supervised CRAs, including their strategy and projections. This will inform our risk analysis on the industry trends, facilitate peer comparisons, as well as allow an early identification of those risks that might have the potential to crystallise in individual CRAs or the industry as a whole in the medium to long-term.

Another area where we see potential for development is the level of engagement with external stakeholders. A stronger interaction with third parties having a stake in how the credit rating industry operates (e.g. issuers of financial instruments, rating users) is an opportunity to both increase our understanding of the market's drivers and expectations, as well as identifying and raising transparency on standards and good practice at industry level as a whole.

5 CRA policy work plan for 2014 and beyond

5.1. CRA3 implementation

Draft RTS

Following the publication of the discussion paper on 10 July 2013 on CRA3 implementation, in 11 February 2014 a consultation paper was published containing a first draft of the three draft RTSs[22]. On the basis of the feedback received, ESMA will submit the draft RTSs to the EC by July 2014. ESMA also started the work on the complex implementing process concerning the IT infrastructure necessary for the implementation of the three RTSs.

Q&As

In order to provide further clarifications concerning the practical application of CRA3, the Q&As published on 17 December 2013 will be updated in 2014 with further questions received from CRAs and market participants. Such Q&As might be further developed into Guidelines and Recommendations.

5.2. Reports and Technical Advice

During 2014 policy work will start on the report to the EC on the possibility of establishing one or more mappings of credit ratings (Article 21(4b) of the Regulation).

Moreover, in 2014 we will also start working on the following technical advice documents to the EC:

- review of the situation in the credit rating market for structured finance instruments, in particular the credit rating market for re-securitisations (Article 39(4)), as well as review of the situation in the overall credit rating market (Article 39(5)); and

- steps taken as regards the deletion of references to credit ratings which trigger or have the potential to trigger sole or mechanistic reliance on ratings and alternative tools to enable investors to make their own credit risk assessment of issuers and of financial institutions (Article 39b(1)).

Finally, policy work might also be needed in 2014 on requests for technical advice ESMA might receive from the EC concerning the appropriateness of the development of a European creditworthiness assessment for sovereign debt and of supporting a European credit rating agency dedicated to assessing the creditworthiness of Member States' sovereign debt and/or a European credit rating foundation (Article 39b(2)).

[22] ESMA/2014/150 (11 February 2014) – Consultation Paper on CRA3 implementation

5.3. Cooperation with other regulators

ECAI network

In the context of Article 136 of the CRR Regulation, ESMA will continue cooperating with EBA to develop the required draft ITS on *mapping*. The consultation paper on the draft ITS on mapping has been adopted by the Joint Committee of the ESAs[23]. Final adoption of the draft ITS will take place by the end of June 2014.

Guidelines and recommendations on reducing reliance on ratings

By the end of 2014, the Joint Committee of the ESAs plans to adopt a set of Guidelines and Recommendations on the supervision by the sectoral competent authorities (SCAs) of reliance on ratings by financial intermediaries. The issue of reducing mechanistic reliance on ratings was first identified at FSB/G20 level at the end of 2010, when it was agreed that action was needed to reduce the risks of herd behaviour by investors deriving from over-reliance on credit ratings. The European legislator has since then implemented the G20 mandate through financial legislation, including the CRA3 legislative package. ESMA will cooperate with EBA and EIOPA in the course of 2014 in the preparation of the Guidelines.

International cooperation

During 2014, ESMA will continue its cooperation with IOSCO Committee 6 including:

- contributing to the finalisation of the revision of the IOSCO Code of Conduct for CRAs;
- the enhancement of our on-going dialogue with third-country authorities belonging to Committee 6; and
- the possible addition of new mandates to Committee 6.

5.4. Endorsement and equivalence

During the second half of 2014 ESMA will work on the decisions regarding the status of other third countries for the purpose of rating endorsement. If requested, ESMA will also provide its advice to the EC on the equivalence of the legislative and regulatory regime in such countries.

[23] JC/CP/2014/01 (5 February 2014) – Consultation Paper: Draft Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation-CRR)