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**COVER NOTE**

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from: Secretary-General of the European Commission,  
signed by Mr Jordi AYET PUIGARNAU, Director

date of receipt: 21 March 2012

to: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European  
Union

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Subject: COMMISSION DELEGATED REGULATION (EU) No .../... of 21.3.2012  
supplementing Regulation (EC) No 1060/2009 of the European Parliament and  
of the Council of 16 September 2009 on credit rating agencies by laying down  
regulatory technical standards for the assessment of compliance of credit rating  
methodologies

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Delegations will find attached Commission document C(2012) 1803 final.

Encl.: C(2012) 1803 final



EUROPEAN COMMISSION

Brussels, 21.3.2012  
C(2012) 1803 final

**COMMISSION DELEGATED REGULATION (EU) No .../..**

**of 21.3.2012**

**supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies**

(Text with EEA relevance)

## **EXPLANATORY MEMORANDUM**

### **1. CONTEXT OF THE DELEGATED ACT**

Article 21 (4) (d) of Regulation (EC) No 1060/2009 as amended by Regulation (EU) No 513/2011 empowers the Commission to adopt, following submission of draft standards by the European Securities and Markets Authority (ESMA), and in accordance with Article 10 or Regulation (EU) No 1095/2010, delegated acts on regulatory technical standards with regard to the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of the Regulation.

In accordance with Articles 10 to 15 of Regulation (EU) No 1095/2010 establishing ESMA, the Commission shall decide within three months of receipt of the draft standards whether to endorse the drafts submitted. The Commission may also endorse the draft standards in part only, or with amendments, where the Union's interests so require, having regard to the specific procedure laid down in those Articles.

### **2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT**

In accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1095/2010, ESMA has carried out a public consultation on the draft technical standards submitted to the Commission in accordance with Article 21 of Regulation (EC) No 1060/2009. A consultation paper was published on the ESMA internet site on 19 September 2011, and the consultation closed on 21 October 2011. Moreover, ESMA also consulted EBA and EIOPA on the draft RTS and invited the Securities and Markets Stakeholder Group set up in accordance with Article 37 of Regulation (EU) No 1095/2010 to provide advice on them. Together with the draft technical standards, ESMA has submitted an explanation of how the outcome of these consultations has been taken into account in the development of the final draft technical standards submitted to the Commission.

### **3. COSTS AND BENEFITS OF THE ACT**

Together with the draft technical standards, and in accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1095/2010, ESMA has submitted an analysis of the costs and benefits related to the draft technical standards submitted to the Commission. This analysis is available at: [http://www.esma.europa.eu/system/files/2011\\_462.pdf](http://www.esma.europa.eu/system/files/2011_462.pdf).

The analysis examines the cost and benefits that are linked to the implementation of the technical standard in respect of the assessment of compliance of credit rating methodologies with the requirements set out in Article 8 (3) of Regulation (EC) No 1060/2009.

The conclusions of the analysis assign preference to the option consisting in requiring CRAs to submit specific information on how they shall demonstrate their compliance with Article 8(3) of the Regulation.

The preferred option is expected to improve transparency and quality of the credit rating methodologies and to better facilitate the assessment of the compliance of CRAs with Article

8(3). The benefits of this option do not seem to be offset by higher relative cost linked to the implementation of the technical standard.

#### **4. LEGAL ELEMENTS OF THE DELEGATED ACT**

Article 1 of the delegated act sets out the subject matter of the Regulation. Article 2 obliges the credit rating agencies to demonstrate their compliance with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009 and Article 3 requires ESMA to examine the compliance of credit rating agencies with those requirements as specified by Articles 4 to 7 of this delegated act.

Article 4 specifies the conditions that credit rating agencies' methodologies have to fulfil in order to be considered by ESMA as robust.

Article 5 specifies the conditions under which credit rating agencies' methodologies can be considered as systematic.

Article 6 specifies the conditions under which credit rating agencies' methodologies can be considered as continuous.

Article 7 specifies the conditions under which ESMA will consider a credit rating methodology to be subject to validation based on historical experience including back-testing.

Finally, Article 8 provides the timeline for the entry into force of the delegated act.

**COMMISSION DELEGATED REGULATION (EU) No .../..**

**of 21.3.2012**

**supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies**

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies<sup>1</sup>, and in particular point (d) of Article 21(4) thereof,

Whereas:

- (1) Article 8(3) of Regulation (EC) No 1060/2009 requires a credit rating agency to use credit rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.
- (2) This Regulation is necessary to ensure transparency in the assessment carried out by the European Securities and Markets Authority (ESMA) established by Regulation (EU) No 1095/2010 of the European Parliament and the Council of 24 November 2010[insert a reference to the establishing regulation] and uniform rules regarding the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009.
- (3) ESMA has to assess the compliance of credit rating agencies with the provision of Article 8 (3) of Regulation (EC) No 1060/2009 when examining applications for registration pursuant to Article 15 of that Regulation. After the registration ESMA should assess as part of its ongoing supervision the continuous compliance of credit rating agencies with the provision of Article 8 (3) whenever it considers such assessment necessary.
- (4) Regulation (EC) No 1060/2009, in particular Article 23 thereof, does not permit ESMA, the Commission or any public authorities of a Member State to interfere with the content of credit ratings or methodologies. Accordingly, this Regulation should lay down the rules by which those methodologies are to be assessed but should not provide for those authorities to decide on the accuracy of a credit rating produced by those methodologies.

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<sup>1</sup> OJ L 302, 17.11.2009, p.1.

- (5) Article 6(2) when read in conjunction with Point 9 of Section A of Annex I of Regulation (EC) No 1060/2009 requires a credit rating agency to establish a review function responsible for periodically reviewing its methodologies, models and key rating assumptions, such as mathematical or correlation assumptions, and any significant changes or modifications thereto as well as the appropriateness of those methodologies, models and key rating assumptions where they are used or intended to be used for the assessment of new financial instruments.
- (6) This Regulation is based on the draft regulatory technical standards submitted by ESMA to the Commission for endorsement by the Commission pursuant to the procedure laid down in Article 10 of Regulation (EU) No 1095/2010.
- (7) ESMA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Securities and Markets Stakeholder Group established under Article 37 of Regulation (EU) No 1095/2010. In addition, ESMA has launched a call for evidence in May 2011 in order to gather information from market participants.

HAS ADOPTED THIS REGULATION:

*Article 1*  
*Subject matter*

This Regulation lays down the rules to be used in the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009.

*Article 2*  
*Demonstration of compliance*

A credit rating agency shall at all times be able to demonstrate to ESMA its compliance with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009 relating to the use of credit rating methodologies.

*Article 3*  
*Assessment of compliance by ESMA*

1. In addition to examining the compliance of credit rating agencies with the provision of Article 8 (3) of Regulation (EC) No 1060/2009 in relation to an application for registration according to Article 15 of that Regulation, ESMA shall examine compliance by each credit rating agency with Article 8(3) of Regulation (EC) No 1060/2009 on an ongoing basis as ESMA considers appropriate.
2. When examining the compliance of credit rating agencies with the provision of Article 8(3) of Regulation (EC) No 1060/2009 ESMA shall use all information relevant to assess the process of developing, approving, using and reviewing credit rating methodologies.

3. In determining the appropriate level of assessment, ESMA shall consider whether a credit rating methodology has a demonstrable history of consistency and accuracy in predicting credit worthiness and may have regard to methods of validation such as appropriate default or transition studies designed to test that specific methodology.

#### *Article 4*

##### *Assessing that a credit rating methodology is rigorous*

1. A credit rating agency shall use and apply credit rating methodologies which:
  - (a) contain clear and robust controls and processes for their developments and related approvals that allow suitable challenge;
  - (b) incorporate all driving factors deemed relevant in determining creditworthiness of a rated entity or a financial instrument which shall be supported by statistical, historical experience or evidence;
  - (c) consider the modelled relationship between rated entities or financial instruments of the same risk factor and risk factors to which the credit rating methodologies are sensitive;
  - (d) incorporate reliable, relevant and quality related analytical models, key credit rating assumptions and criteria where these are in place.
2. A credit rating agency shall list and provide a detailed explanation of the following points with regard to the credit rating methodologies used regarding:
  - (a) each qualitative factor, including the scope of qualitative judgment for that factor;
  - (b) each quantitative factor, including key variables, data sources, key assumptions, modelling and quantitative techniques.
3. The detailed explanation referred to in paragraph 2 shall include the following:
  - (a) a statement of the importance of each qualitative or quantitative factor used within that credit rating methodology including, where relevant, a description of and justification for related weightings assigned to those factors and their impact on credit ratings;
  - (b) an assessment of the relationship between the key assumptions used in that credit rating methodology and the critical risk factors derived from macroeconomic or financial data; and
  - (c) an assessment of the relationship between the key assumptions used in credit rating methodology and the volatility of credit ratings produced by that methodology over time.
4. A credit rating agency shall use credit rating methodologies and their associated analytical models, key credit rating assumptions and criteria that promptly

incorporate findings or outcomes from an internal review or a monitoring review undertaken by one or more of the following:

- (a) the credit rating agency's independent members of the administrative or supervisory board;
- (b) the credit rating agency's review function;
- (c) any other relevant person or committee involved in the monitoring and reviewing of credit rating methodologies.

#### *Article 5*

##### *Assessing that a credit rating methodology is systematic*

1. A credit rating agency shall use a credit rating methodology and its associated analytical models, key credit rating assumptions and criteria that are applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it.
2. A credit rating agency shall use a credit rating methodology which is capable of promptly incorporating the findings from any review of its appropriateness.

#### *Article 6*

##### *Assessing that a credit rating methodology is continuous*

1. A credit rating agency shall use credit rating methodologies shall that are designed and implemented in a way that enables them to:
  - (a) continue to be used unless there is an objective reason for the credit rating methodology to change or be discontinued;
  - (b) be capable of promptly incorporating any finding from on-going monitoring or a review, in particular where changes in structural macroeconomic or financial market conditions would be capable of affecting credit ratings produced by that methodology;
  - (c) compare credit ratings across different asset classes.

#### *Article 7*

##### *Assessing that a credit rating methodology is subject to validation based on historical experience including back testing*

1. A credit rating agency shall use credit ratings methodologies that are supported by quantitative evidence of the discriminatory power of the credit rating methodology.
2. A credit rating agency shall use credit rating methodologies that describe the following:



- (a) the historical robustness and predictive power of credit ratings issued using the relevant methodology over appropriate time horizons and across different asset classes;
  - (b) the degree to which the assumptions used in the rating model deviate from the actual default and loss rates.
3. The validation of a credit rating methodology shall be designed to:
- (a) examine the sensitivity of a credit rating methodology to changes in any of its underlying assumptions, including qualitative or quantitative factors;
  - (b) perform an adequate and appropriate assessment of historic credit ratings produced by means of that credit rating methodology;
  - (c) use reliable inputs, including appropriate size of the data samples;
  - (d) take appropriate account of the main geographical areas of the rated entities or financial instruments for each of the credit rating categories rated such as structured finance, sovereign, corporates, financial institutions, insurances, public finance.
4. A credit rating agency shall have processes in place to ensure that systemic credit rating anomalies highlighted by back-testing are identified and are appropriately addressed.
5. In the process of reviewing credit rating methodologies, a credit rating agency shall include:
- (a) regular credit rating and performance reviews on rated entities and financial instruments;
  - (b) in-sample and out-of-sample testing;
  - (c) historic information on validation or back-testing.

*Article 8  
Exemption*

In cases where there is limited quantitative evidence to support the predictive power of a credit rating methodology, a credit rating agency shall be exempt from complying with Article 7 of this Regulation if it:

- (b) ensures that credit rating methodologies are sensible predictors of credit worthiness;
- (c) applies internal procedures in a consistent way and over time and across different market segments;
- (d) has processes in place to ensure that systemic credit rating anomalies highlighted by back-testing are identified and are appropriately addressed.

*Article 9*  
*Entry into force*

This Regulation shall enter into force on the 20th day following its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 21.3.2012

*For the Commission*  
*The President*  
*José Manuel BARROSO*