European Securities and Markets Authority

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The Chair

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Ms Christine Lagarde
Chair
European Systemic Risk Board
Sonnemannstrasse 20
60314 Frankfurt am Main
Germany

Ref: Reply to ESRB letter on procyclical impact of downgrades of corporate bonds on markets and entities across the financial system

Dear Ms Lagarde, Dear Christine,

Following my initial response to your letter dated October 1, 2020 on the procyclical impact of downgrades of corporates bonds, please find below ESMA's more detailed views. ESMA fully supports the important work that ESRB has carried out in this area over the course of 2020. ESMA has been actively involved in this topic, not only at the ESRB level, but also in several international workstreams.

I would like to take this opportunity to reply to some of the key issues mentioned in your letter. More specifically, I will focus on the two actions proposed in your letter regarding the transparency of CRA methodologies and contractual references to credit ratings, by providing an overview of:

- The current state of play from a regulatory perspective, highlighting aspects of the CRA Regulation and ESMA's activities that are relevant in the context of your letter;
- ESMA's preliminary observations on the definition of ratings, the rating "through-the-cycle" concept and the timely incorporation of information in credit ratings by CRAs; and
- Possible follow-up work on contractual references to credit ratings and the transparency on some of the more technical aspects of CRA methodologies.

1 Regulatory framework regarding transparency

Transparency of CRA methodologies and rating actions is a key objective of the CRA Regulation and for ESMA, and plays an important role in the context of enhancing investor protection and promoting stable and orderly financial markets. Under the CRA Regulation, CRAs are required to make extensive public disclosures regarding the methodologies, models, and key rating assumptions used in their creditworthiness assessments.

In addition, when introducing new methodologies or making material changes to existing methodologies, CRAs are required to hold a public consultation and publish a detailed explanation of the reasons and the implications of the proposed material changes or new rating methodologies.

Furthermore, the CRA Regulation sets out rules on the presentation of credit ratings to enhance the transparency around the key drivers of rating actions and the methodologies used in determining the credit rating. When presenting credit ratings or rating outlooks, CRAs should, among others, be transparent on the meaning of each rating category, the definition of default and provide a sensitivity analysis of the relevant key rating assumptions used.

2 ESMA's supervisory and policy activities

ESMA uses a range of supervisory tools to assess how CRAs adhere to the regulatory requirements mentioned above. For example, as part of its ongoing supervision, ESMA regularly reviews CRA methodologies to ensure they are rigorous, systematic, and continuous, but also transparent to allow investors to understand the underlying methodological approach. Below I provide an overview of a number of relevant workstreams related to the transparency of methodologies and credit ratings.

In 2019, ESMA assessed some of the disclosure requirements applicable to credit ratings and noted an inconsistent level of disclosure. Therefore, ESMA issued guidelines to improve the quality and consistency of the information disclosed following a credit rating action.

ESMA also receives the daily rating activity of all the registered CRAs. This information is included in two registers, the European Rating Platform (ERP) and the Central Repository (CEREP). These registers provide access to information on credit ratings and rating outlooks, rating activity and performance statistics including transition matrices and default rates.

In 2020, ESMA concluded a review[1] on the rating process and methodologies that CRAs follow when issuing credit ratings on collateralised loan obligations (CLOs). Although the review was focused on CRAs' methodological approaches, the final report also covered transparency aspects. For example, ESMA indicated that CRAs should be transparent on their modelling approaches, assumptions and the sensitivity of CLO credit ratings, which is especially important in the context of extreme scenarios like a COVID-19 pandemic.

3 Preliminary observations

Below, I share ESMA's preliminary observations on the transparency around certain elements of CRA methodologies, including the definition of ratings, the rating "through-the-cycle" concept and the timely incorporation of information by CRAs.

[1] See ESMA, *Thematic Report on EU CLO credit ratings – an overview of Credit Rating Agencies practices and challenges* (ref: ESMA80-189-6982), May 2020.

Based on an initial review, ESMA is of the opinion that there is sufficient transparency around credit rating definitions, rating scales and rating symbols used by CRAs. Rating definitions often contain forward-looking elements, are measured in relative terms, and can be classified as either long- or short-term depending on the maturity of the rated obligation.

Regarding the rating “through-the-cycle” concept, ESMA understands this concept as referring to the fact that credit ratings are not expected to be overly volatile and are not expected to change frequently during a business cycle. It is important to note that this concept is not part of the CRA Regulation. Therefore, CRAs can chose to provide point-in-time credit ratings or credit ratings that include more forward-looking elements as long as this is properly documented. ESMA found that CRAs describe their rating approach, i.e. the balance between cyclical or more permanent elements, in research papers and methodologies. For example, CRAs provide information on their rating modelling approach, key assumptions used and other methodological inputs. CRAs also regularly publish rating statistics, e.g. quantitative measures of rating stability, which provide some transparency on how credit ratings behave over time. At the same time, ESMA’s preliminary assessment also shows that the quantity and quality of information available on CRAs’ rating approaches varies across CRAs and is not always easily accessible. ESMA will continue its work in this area to ensure CRAs provide a consistent level of disclosure regarding their rating approach.

Another topic that ESMA reviewed is the timely incorporation of new information and changes in fundamentals, more specifically how CRAs incorporated public support measures deployed during the COVID-19 health crisis. ESMA’s assessment here is based on recent work done by IOSCO on the impact of COVID-19 government support measures (GSMs) on credit ratings and CRA methodologies.[2] IOSCO finds that CRAs considered the economic shock and the resulting credit consequences caused by the pandemic. CRAs also considered the impact of GSMs in their credit ratings during and after the onset of the pandemic. IOSCO further states that CRAs were generally transparent on the impact of GSMs if these were material to the rating decision.

4 Follow-up work

ESMA has prioritised several workstreams in its 2021 work programme that are relevant in the context of the transparency of CRA methodologies. For example, ESMA will perform further work on the impact of COVID-19 and actively follow-up on any risks identified in outstanding credit ratings, while continuing to work on the accessibility and usability of credit ratings.

ESMA also acknowledges the points made in your letter regarding the risks of mechanistic reliance on credit ratings by market participants. Recent work performed by the FSB confirms this risk.[3] Credit ratings are used in several ways throughout the financial system, for example to define the investment universe of an investor or constructing benchmarks. As a result,

[2] See IOSCO, *Final Report on the Observed Impact of COVID-19 Government Support Measures on Credit Ratings* (ref: FR02/2021), February 2021.
[3] See FSB, *COVID-19 Pandemic: Financial Stability Impact and Policy Responses*, November 2020.

downgrades of bonds that are included in a benchmark that is tracked by passive investors could lead to greater sales by investors. In times of stress, such downgrades could potentially have a procyclical impact. Therefore, ESMA is supportive of further work regarding the monitoring and reporting of contractual references to ratings. As indicated in your letter, it is important to have a clear picture of possible systemic issues that may arise in stressed market conditions as a result of contractual references to credit ratings. ESMA looks forward to further engaging on this topic with ESRB and the European Commission.

Finally, ESMA looks forward to continuing the dialogue with the ESRB and the European Commission regarding, for example, the "through-the-cycle" concept and the transparency around some of the more technical aspects of CRA methodologies, including the probability of default, loss-given default and correlation of defaults. I would like to conclude by reiterating ESMA's support to improving the transparency around CRA methodologies and rating actions taken by CRAs within the context of the CRA Regulation.

Yours sincerely,

Steven Maijoor