TO:

European Securities and Markets Authority ("ESMA")

Submitted via WEB

Reference: Consultation on "Internal Controls for CRAs"

Date: March 16th, 2020

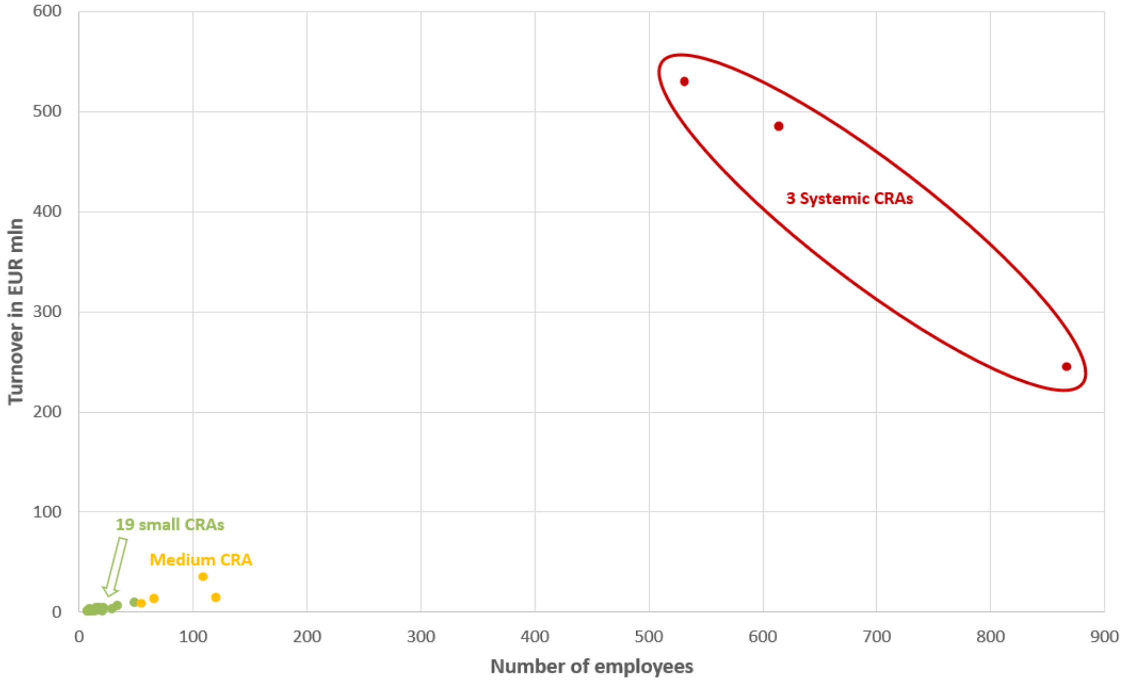
Dear ESMA,

With reference to your consultation paper ("CP") on "guidelines on Internal Controls for CRAs", we are pleased to hereby submit the views of our association, who represents around half of all small to medium-sized CRAs registered with ESMA. We thank you for holding the open hearing on February 24th, 2020 in Paris as it was well attended by ESMA and CRAs, triggering a good exchange of views. We appreciated that ESMA is willing to listen and consider the concerns of CRAs.

We welcome that the proposed guideline is very well structured and contains a great level of details extending to all areas of a CRAs. But, we are concerned that these guidelines reflect the operations of systemic CRAs and that smaller agencies will face great challenges to implement these. We believe that more proportionality needs to be provided and that this should be reflected with clearer guidance to CRAs.

§5 9 page 27 of the CP, mentions that "The CRA Regulation is prescriptive in the area of CRA's internal control systems due to the systemic importance of credit ratings to financial stability and investor protection in the EU." While we agree that credit ratings, as a whole, are of systemic importance, this does not apply to all credit rating agencies. Based on our research of banks disclosures under Article 444 of CRR, we note that banks systemically reference one or several of the Dominant 3 CRAs as nominated ECAIs while other CRAs (all being Elligible ECAIs) are rarely used for capital requirements calculations. ESMAs yearly CRA market share reports as well as the recent ESMA Supervision Annual Report 2019 evidences the special status of these 3 agencies. Given that small CRAs are NOT of systemic importance, we believe that the requirements set out in this guideline need to be adapted and provide for more proportionality.

The below graph summarizes the current market structure in the rating industry (based on the Transparency reports of CRAs for 2018) in terms of number of employees and turnover in the EU:



Sources: Transparency reports of ESMA registered CRAs for the year 2018. Includes estimates for not disclosed information.

Out of 26 ESMA registered CRAs, the vast majority are small agencies operating with less than 50 employees, 4 are medium-sized having less than 150 employees and 3 dominate the market with more than 500. We believe that the guidelines should better reflect the population of supervised entities.

ESMA mentions that it developed the guideline based on the COSO Internal Control – Integrated Framework dated may 2013 ("Framework") as well as the EBA guideline on Internal controls dated 2017. We note that the Executive summary of the Framework states on page 1 that it "provides a (…) principles-based approach that provides flexibility and allows for judgment in designing, implementing, and conducting internal control". Page 2 mentions that "The Framework applies to all entities: large, mid-size, small (…). However, each organization may choose to implement internal control differently. For instance, smaller entity's system of internal control may be less formal and less structure, yet still have effective internal control."

The ESMA guideline follows the EBA benchmark on the topic, which includes a section on proportionality and defines a set of criteria "in order to ensure an appropriate implementation of the requirements" (page 17 of the EBA Guideline on internal governance dated September 2017). We would welcome if ESMA defines a similar set of proportionality criteria, thresholds.

At the same time, we believe that the comparison with the banking industry is not helpful: The EU 28 banking sector is composed of approx. 6.000 credit institutions employing a total of 2,6 mln persons. (While large banks may employ more than 10.000 of staff, we assume that an average small bank employs between 50 to 100 persons). The EU 28 rating industry is composed of 26 registered rating agencies employing a total of 2.800 staff, small CRAs operating with 10 to 30 employees. Given the size of the banking industry, banks can easily outsource activities to professional consulting firms having the required expertise. Given the narrowness of the rating industry, finding consulting firms familiar with the peculiarities of the CRA Regulation and the rating industry is far more difficult – outsourcing of IC functions to such external service providers will result in costs but will provide little value to the CRA.

The "guidelines on the submission of Periodic Information to ESMA by Credit Rating Agencies" dated February 2019 provides for different reporting deadlines and contents depending on the ESMA risk classification, Category B agencies having to comply with a reduced reporting requirement. Under this reporting framework, several items relating to "Internal control" are marked "upon demand". The explanatory text states "where a CRA has established an Internal Audit function", implying that such an Internal Audit function is not mandatory.

With respect the Internal Control Framework, we note that it covers a wide set of best practice. But, we are concerned that ESMA expects that all elements be applied across all agencies (see § 15 page 8 of the CP). Such an extensive IC Framework corresponds to a large bureaucratic effort for small CRAs, both in terms of implementation and on-going monitoring.

With respect the Internal Control Functions, we would appreciate better guidance to small CRAs in case where a dedicated function does not exist. Additionally, we recommend that ESMA defines thresholds based on which ESMA would accept to consider alternative proposal as a solution to mitigate risks and improve specific controls.

Below you shall find our responses to your specific questions which contain some practical implications of the proposed guidelines on smaller agencies as well as some proposals to address these issues.

We remain at your disposal for any additional information or clarification. We trust that our comments are beneficial towards developing suitable guidelines applicable to all sizes of agencies.

Q1 Do you have any comments on the proposed Guidelines under the section on IC Framework? In providing your comments please refer to the general principle, component and/or characteristic that you are commenting on.

We are particularly concerned with the last of sentence of § 23 (as well as point 1.3.3 item 2) stating that "staff members responsible for the development or implementation of credit rating methodologies should not be responsible for their review or validation". This implies that the Review function needs to be split into 2 components, development/review on the one hand and validation on the other. This requirement goes beyond the requirement of the CRA Regulation which only requires the establishment of a review function. Furthermore, this requirement contradicts the wording in § 39 page 19 of the CP as well as point 2.2 page 20 ("The CRA's review function is also responsible for validating new methodologies"). From the perspective of small CRAs, the guidelines should make clear that review and validation of rating methodologies can be done by one function. As the term "implementation of a methodology" may be confusing, we propose that the text should be revised to state that "the review function does not participate in the rating process". Our primary reason for this comment is to protect quality of methodology development and reliance on individuals with relevant experience and skill sets within small organisation.

The requirement in Points 1.3.2 results in 2 persons being required to carry out the control (one performing the control and one responsible for reviewing the control). Given the requirements in §33 and 34, it will be very difficult or impossible for small CRAs to implement this requirement. For small CRAs, it should be enough that only 1 person is being used.

Q2 Are there any other comments you wish to raise on this section?

With reference to component 1.2 Risk Management, we agree that the tasks listed should be covered by a CRA, but CRAs should remain free how to implement these. Based on the scope of operations, this could be done either by the compliance function, an INED or an external party.

Q3 Do you have any comments on the proposed Guidelines under this section? In providing your comments please refer to the general principle, component and/or characteristic that you are commenting on.

With respect the review function (component 2.2) page 20 of the CP, we note that the definition includes a review of credit rating methodologies on "at least an annual basis". This contrasts with the text of the CRA Regulation (Annex I Section A point 9) using the term "periodically", which could imply a longer time frame.

Point 2.5.5. requires that the internal audit function "adheres to international internal audit standards and leading practices". While this requirement is laudable, for small CRAs this target is overshooting and leads most probably to high training costs compared to a narrow scope of activities.

Q4 Are there any other comments you wish to raise on this section?

With reference to § 44 page 22 of the CP on the Information Security Function, "ESMA expects larger CRAs with more credit rating activities of greater complexity to establish such a function". The definition of this component (point 2.4) states that "This function should be independent from operational functions and organisational structures, such as IT or other functions with operational duties". From the perspective of small CRAs, we propose that the definition incorporates a clearer materiality threshold below which this Function may be assigned to the operational IT function as this task involves specific IT knowledge as stated in the second sentence of §44. In order to ensure legal certainty, this sentence should be included in the text of the guideline itself (§24 page 38).

Regarding internal audit, we note that the definition of the component (2.5) and its characteristics do not exclude the fact that this is being performed by the compliance function. But, § 32 page 17 states "combinations of the internal audit function with another internal control function, such as compliance and the review function or risk management, should be ruled out." This paragraph represents a very strong limitation and is not reflected in the text of the guideline (page 38 and 39 of the CP). § 45 page 23 of the CP states that "the responsibilities could be assigned to a suitably qualified Independent Non-Executive Director or an appropriate external party". As small CRAs may be exempted from having Independent Non-Executive Directors, CRAs should have the option to assign this function to compliance.

Q5 Do you agree with the cost benefit analysis as it has been described?

If small CRAs were to implement all proposed requirements with separate resources, this will substantially drive up administrative costs as additional people would need to be hired.

Given that CRAs need to include in their yearly transparency report a description of their internal control mechanisms, users of ratings can already now assess the measures taken by CRAs. Given that proportionality is a topic widely discussed across all market segments, users of ratings will assess whether these control mechanisms are commensurate to the size of the CRAs operations.

As § 57 also states "that the guidelines will act not only as a supervisory handbook against which ESMA supervisors can assess each CRA's internal control systems and mechanisms". EACRA considers the proposed guideline to be disproportionate to the nature and scale of small CRA and as result EACRA will welcome revisions incorporating higher flexibility and proportionality for small CRAs, allowing them to comply with the proposed guideline.

Q6 Do you have any comments on the proportionality for smaller CRAs provided in the Guidelines?

As already mentioned in our introductory remarks above, we believe that the guideline is too detailed and prescriptive and that small and medium sized agencies will face real challenges to implement it in an appropriate and effective manner. Instead of creating 5 separate functions and requiring a high documentation effort, the target should be that the IC framework are being performed in such a way that they correspond to the size of the agencies. The larger and more complex a CRA gets, the more the IC functions should be sophisticated and staffed.

While the CP lists a total of 5 Internal Control Functions (compliance, review, risk management, information security and internal audit), we note that the CRA Regulation only cites the first two (compliance and review) and is silent on the other 3. Given that the CRA Regulation provides the option to small CRAs having less than 50 employees to get exempted from these 2 functions, we recommend that the guideline explicitly clarifies that small agencies are not mandated to set up all functions.

the CP discloses in § 37 ESMAs expectation that all CRAs should have a compliance officer. To our knowledge, this best practices, although above the minimum standards foreseen in the CRA Regulation, has been implemented by all EACRA Members registered with ESMA (some using parttime employees or having outsourced the position to qualified third parties), in order to cope with §33 page 17 of the CP setting high requirements on the staff in charge of IC functions (in terms of seniority, independence and direct reporting to the Board). .

When looking at the definitions of each IC Function, we note that these are complementary to each other and there are no apparent oppositions or conflicts of interests between the different functions. Therefore, in theory, all these functions (excluding the review function which is very specific to CRAs) could be executed by a single, highly skilled person exercising different roles. The additional organisational requirements listed in §34 can hardly be met within a small CRA since the number of staff is too low to respect all 3 elements

The CP already includes some proportionality in § 36 page 19 of the CP stating that "the CRA should ensure that the staffing and resources of its IC functions are appropriate to the nature, scale and complexity of its operations". In § 40 page 20 of the CP, ESMA expects the Risk Management Function to be relevant for "CRAs of significant scale and complexity" whereas in § 44 page 22 of the CP the Information Security Function is expected for "larger CRAs with more credit rating activities of greater complexity". Instead, we would welcome if ESMA provides more clarity on these thresholds triggering the set-up of an additional function.

Sincerely yours

Thomas Missong	Adolfo Estevez Beneyto
EACRA President	EACRA Secretary General

About EACRA

The European Association of Credit Rating Agencies ("EACRA"), registered in Paris, was established in November 2009. The Members of the Association currently originate from 10 countries and include the following companies:

ESMA registered Credit Rating Agencies

ACRA Europe (formerly European Rating Agency, ERA) was established in 2001 and in June 2012, ERA became a registered credit rating agency under EU regulations, which allows assigning ratings for regulatory purposes. ACRA Europe is a wholly owned subsidiary of ACRA, the leading credit rating agency in the CIS.

A.M. Best Europe - Rating services Limited (AMBERS) is a subsidiary of A.M. Best Inc who have been providing ratings to the Insurance Sector since 1899. AMBERS' rating coverage includes regional, national and global insurers located throughout Europe, the Middle East and Africa.

Assekurata Assekuranz Rating-Agentur is the first independent German rating agency that has specialized on the quality evaluation of insurance companies

Axesor: The first Spanish Rating agency registered with ESMA. Specialized in the middle market segment, with ample coverage of the Spanish corporate market.

Capital Intelligence (CI) offers independent rating opinions on financial institutions, corporates and governments in a wide range of countries, especially the emerging markets of Asia, Europe and the Middle East.

Cerved Rating Agency is a European Rating Agency providing solicited and unsolicited credit ratings on non-financial companies. The Agency is also recognized by the European Central Bank as a Rating Tool authorized to assess the credit quality of eligible assets used in ECB monetary policy operations.

Creditreform Rating: based in Germany, a company of the Creditreform Group that is European market leader in the sector of business information was founded 2000 and is specialised in ratings of companies, bonds, funds and structured finance products across Europe.

Euler Hermes Rating is a European rating agency located in Hamburg, Germany. We offer credit ratings and research about debt capital market instruments of corporates of all sorts of industries, project finance ratings and credit portfolios. Euler Hermes Rating is a member of Euler Hermes Group and a company of Allianz

Nordic Credit Rating assigns credit ratings to financial institutions and corporate entities based primarily in Denmark, Finland, Iceland, Norway and Sweden.

Scope Ratings is the leading European credit rating agency, offering clients opinion-driven, forward-looking and non-mechanistic credit risk analysis and contributes to a greater diversity of opinions for institutional investors. Scope Ratings is a credit rating agency registered in accordance with the EU rating regulation and operating in the European Union with External Credit Assessment Institution (ECAI) status. It provides ratings and analysis on Corporates, Financial Institutions, Covered Bonds, Public Finance, Structured Finance and Project Finance.

CRAs registered or recognized according to national legislation outside of the European Union

Analytical Credit Rating Agency (ACRA) was founded in 2015, with its 27 shareholders representing major Russian corporate and financial institutions. ACRA’s main objective is to provide the Russian financial market with high-quality rating products: methodologies and internal documents of ACRA are developed with regard to global rating industry best practices.

Fedafin AG : is registered with the Swiss Financial Markets Authority and acts as rating provider to the Swiss stock exchange

JCR Eurasia is an international credit rating institution based in Turkey.