

# ESMA's Supervision – 2018 Annual Report and 2019 Work Programme

**Credit rating agencies, trade repositories, third country central counterparties, and third country central security depositories**





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## List of Acronyms

BTRL	Bloomberg Trade Repository Limited
CEREP	CEntral REPOSITORY of credit rating data reported by CRAs to ESMA according to Commission Delegated Regulation 448/2012 of 21 March 2012 with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority
CFTC	U.S. Commodity Futures Trading Commission
CME TR	CME Trade Repository Ltd.
CRA	Credit Rating Agency
CRA Regulation	Regulation (EC) No 1060/2009 on credit rating agencies as amended by Regulation (EU) 513/2011 and Regulation (EU) 462/2013
CSP	Cloud Service Provider
Delegated Regulation on Fees	Delegated Regulation 2015/1 on the reporting of fees charged by credit rating agencies
DDRL	DTCC Derivatives Repository Ltd.
DQAP	Data Quality Action Plan
ECB	European Central Bank
EMIR	Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories
Endorsement Guidelines	Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation, published on 17 November 2017 (ref. ESMA33-9-205)
ERM	Enterprise Risk Management
ESMA	European Securities and Markets Authority



ESMA Regulation	Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority)
ESRB	European Systemic Risk Board
ETD	Exchange Traded Derivative
EU	European Union
Fitch	Credit rating agencies within Fitch Group
Guidelines on Portability	Guidelines on transfer of data between trade repositories (ref. ESMA70-151-1116)
ICE TVEL	ICE Trade Vault Europe Ltd.
IIO	Independent Investigating Officer
INED	Independent Non-Executive Director
IOSCO	International Organization of Securities Commissions
IRF	Independent Review Function
IT	Information Technology
ITS	Implementing Technical Standards
KDPW	Krajowy Depozyt Papierów Wartościowych S.A.
LEI	Legal Entity Identifier
MIS	Moody's Investors Service
MoU	Memorandum of Understanding
Moody's	Credit rating agencies within Moody's Corporation, including Moody's Germany and Moody's UK
Moody's Germany	Moody's Deutschland GmbH
Moody's UK	Moody's Investors Service Limited
NATR	NEX Abide Trade Repository Limited AB
NCA	National Competent Authority



OTC	Over-the-counter
Periodic Information Guidelines	Guidelines on periodic information to be submitted to ESMA by Credit Rating Agencies Guidelines (ref. ESMA/2015/609)
Q&A	Questions and answers
RADAR	ESMA's credit RATings DAta Reporting tool
REGIS-TR	REGIS-TR S.A.
RTS	Regulatory Technical Standard
Securitisation Regulation	Regulation (EU) No 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.
SFTR	Securities Financing Transactions Regulation
SFT TR	Securities Financing Transactions Trade Repository
S&P	Credit rating agencies within S&P Global Inc.
STS Securitisation	Simple, Transparent, and Standardised Securitisation
TC-CCP	Third country (non-European) Central Counterparty
TC-CSD	Third-Country (non-EU) Central Securities Depository
TR	Trade Repository
TRACE	ESMA's Trade Repository Data Reporting tool
UK	United Kingdom
UnaVista	UnaVista Limited
Validation Guidelines	Guidelines on the validation and review of Credit Rating Agencies' methodologies (ref. ESMA/2016/1575)

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## Executive Summary

The European Securities and Markets Authority is publishing its annual report and work programme to highlight its direct supervisory activities during 2018 regarding credit rating agencies (CRAs) and trade repositories (TRs) and outline its main priorities in these areas for 2019. In addition, this document outlines ESMA's activities regarding the monitoring and recognition of third country central counterparties (TC-CCPs) and central security depositories (TC-CSDs) in 2018 and going forward into 2019.

### **Main activities of 2018 and priorities for 2019**

1. ESMA's supervisory activities and achievements in 2018 are:

#### TR and CRA supervision

- Supervision of eight registered TRs, 27 registered CRAs and four certified CRAs;
- Supervisory work to improve the quality of data reported by TRs through the Data Quality Action Plan, engagement with data users, and monitoring of the implementation of the new validation requirements and the Guidelines on Portability;
- Investigations into the rating process and the rating methodology framework of CRAs, and into the development, approval, and validation of a specific model and the related rating methodology of a CRA;
- Ongoing work on the contingency plans set up by CRAs and TRs in light of Brexit;
- Continuation of the supervisory project on the use of cloud computing services in the TR and CRA industry;
- Finalisation of the thematic review of fees charged by CRAs and TRs and publication of report on the outcome of this review and the way forward (published on 11 January 2018); and
- Imposition of a fine of EUR 495,000 each to Danske Bank, Nordea Bank, Svenska Handelsbanken, Swedbank, and SEB for failure to comply with requirements of the CRA Regulation concerning the necessary authorisation to issue credit ratings.

#### TC-CCPs

- Monitoring of the activities and services provided by recognised TC-CCPs in the EU;
- Data gathering on interlinkages and exposures of EU entities with those TC-CCPs;
- Data analysis of the potential risks TC-CCPs might bring to the EU; and



- Communication and preparation work for the recognition of UK CCPs.

#### TC-CSDs

- Communication and preparation work for the recognition of the UK CSD.

2. At the end of 2018, ESMA also conducted a supervisory risk assessment regarding CRAs and TRs, which identified the following supervisory priorities for 2019:

#### TR supervision

- Data quality and access by authorities, with a particular focus on the Data Quality Action Plan;
- IT process and system reliability;
- Business continuity planning; and
- Information security function.

#### CRA supervision

- Portfolio risk;
- Quality of the rating process; and
- Cybersecurity.

3. In addition, ESMA will perform further work on a number of areas where there are common issues across TRs and CRAs including Brexit, fees charged by CRAs and TRs, the effectiveness of internal control systems, and the use of new technologies.

4. For TC-CCPs, ESMA has identified the following priorities for 2019:

- Recognition of UK CCPs in a no-deal Brexit scenario;
- Assessment of the 19 pending applications for recognition as TC-CCPs;
- Monitoring of the potential risks TC-CCPs might introduce in the EU;
- Monitoring of the impact of Brexit on the third country CCP regime; and
- Preparation for the potential changes in the scope of ESMA supervision of TC-CCPs following the current review of the applicable regulations.

5. For TC-CSDs, ESMA has identified the following priorities for 2019:

- Assessment of the UK CSD application for recognition as a TC-CSD under CSDR in a hard Brexit scenario;
- Monitoring the potential risks that the UK CSD might pose to the European Union or its Member States post-Brexit; and
- Monitoring of the impact of Brexit on the TC-CSD regime.

## **TR supervision**



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ESMA's supervision of TRs started in 2013 with their registration. By November 2013, ESMA had registered six TRs, which triggered the trade reporting obligations to TRs set out in EMIR. Following the registration of two additional TRs in 2017, the total number of TRs registered in the EU amounts to eight. ESMA's supervisory work requires close cooperation with National Competent Authorities (NCAs) in the EU Member States, as NCAs are responsible for supervising the counterparties reporting to TRs. Furthermore, NCAs are amongst the key users of TR data.

Trade reporting to TRs began in February 2014. By November 2018, approximately 65 billion reports had been received by TRs, with an average of approximately 390 million trade reports submitted per week. As a consequence of the UK's decision to withdraw from the EU, the market structure will undergo significant changes as UK-based TRs will have to establish a presence in the EU-27 or cease operations. ESMA has dedicated much effort and many resources to ensure that TRs are ready for porting at the end of 2018 in accordance with the Guidelines on Portability. These Guidelines establish a consistent and harmonised approach to carry out data transfers between TRs when clients migrate from one TR to another. Other regulatory changes, such as the preparation for Securities Financing Transactions Regulation (SFTR) and Securitisation Regulation (SR), will also affect TRs and their relevant stakeholders as reporting and processing technologies will have to be adjusted to the new standards. ESMA expects that several of the TRs currently registered under EMIR will apply for an extension of registration for SFTR and SR.

In 2018, the main topics of ESMA's supervision were data quality and data access by authorities, technology trends, internal controls, governance and strategy of TRs as set out in the TR supervision work programme for 2018.

During 2018, ESMA further increased its engagement with NCAs and data users to improve data quality. An important part of this work focused on the Data Quality Action Plan, which aims to improve the quality and usability of data that is reported to and by the TRs. In addition, ESMA performed two assessments regarding the completeness and alignment of the information reported through the different channels to authorities. ESMA observed significant improvements in the alignment of reports throughout the assessment period.

ESMA also continued its work on inter-TR reconciliation by monitoring the correct implementation of pending corrective actions by TRs and by further analysing the supervisory and statistical information collected around the process. To enhance the monitoring of the progress made in the pairing process as well as to identify additional issues hindering the reconciliation of the reported trades, ESMA has developed and uses a new tool, which simulates the pairing process of the outstanding trades across TRs and generates useful statistics that allow us to take supervisory action where necessary.

ESMA continued to actively engage with TRs regarding their strategic direction and governance, particularly in the context of the UK's decision to withdraw from the EU and

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related changes. In light of this, ESMA had exchanges on both strategic and operational matters with key staff, senior management, and the Boards of Directors. In general, during 2018, ESMA intensified its dialogue with supervised firms in line with their risk profile.

As regards internal control practices and their applicability to the TR industry in 2018, ESMA engaged and interacted more actively with the Internal Audit (IA) function of selected TRs. In addition, following a letter sent to all TRs in 2017, where ESMA expressed its concerns regarding the role of the compliance function and outlined a set of principles to address these concerns, ESMA continued to closely monitor this area in 2018.

Following the implementation of the new RTS/ITS in November 2017, ESMA observed an increase of incidents for several TRs. In this respect, ESMA allocated time and effort to supervise the effective identification of root causes, the prompt remediation, and the strengthening of the respective control environment. To facilitate the implementation of the Guidelines on Portability and support TRs in their joined responsibility of overcoming the IT- and infrastructure-related difficulties, ESMA hosted a roundtable on 16 May 2018 to identify and prioritise major problems related to portability. Following the roundtable and taking into account the considerations TRs brought forward, ESMA provided further communications as to the identified implementation issues and engaged repeatedly with TRs throughout the year to accelerate compliance with the Guidelines on Portability.

For 2019, in addition to the common priorities for TRs and CRAs, the following key priority areas were identified via the 2018 risk assessment for TRs, namely data quality and access by authorities, IT process and system reliability, business continuity planning, and the information security function. In the context of data quality, ESMA will especially focus on the Data Quality Action Plan, the implementation of position calculation reports, and the implementation of the Guidelines on Portability.

### **CRA supervision**

ESMA is currently supervising 27 registered and four certified CRAs. During 2018, ESMA registered two new CRAs and withdrew one registration, increasing the number of CRAs supervised by ESMA by one. As a result of the UK's decision to withdraw from the EU, UK-based CRAs needed to establish CRAs based in the EU-27 if they want to continue to serve the EU market, which led to an increase in the number of applications for registration. However, industry dynamics remained largely the same over the course of 2018 as the CRA industry remains concentrated around three large CRAs.

In 2018, one of the main priorities for ESMA related to the improvement of the quality of the rating process. ESMA used a number of supervisory tools in this area, including dedicated investigations, remedial action plans, and thematic work streams. During 2018, ESMA also further engaged with CRAs regarding the follow-ups in the context of the Validation Guidelines, leading to significant progress as a number of CRAs now align their validation



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measures to include the techniques outlined in the Validation Guidelines. Furthermore, ESMA sent a letter to each CRA's independent members of the Board of Directors regarding their engagement in the validation and review of credit rating methodologies.

In addition, ESMA conducted dedicated investigations into the rating processes and rating methodology framework of CRAs, and into the development, approval, and validation of a specific model and the related rating methodology of a CRA. In 2018, ESMA took one enforcement decision. ESMA's Board of Supervisors found that five banks had committed an infringement of the CRA Regulation concerning requirements for the necessary authorisation to issue credit ratings and imposed on each bank a fine of EUR 495,000.

Following the publication of ESMA's Endorsement Guidelines<sup>1</sup> in 2017, ESMA published a supplement to these updated Endorsement Guidelines in July 2018 on the request of a number of CRAs. The updated Endorsement Guidelines, including the supplement published, took effect on 1 January 2019.

Following the high levels of risk identified in the 2017 risk assessment for IT, information security, and internal controls, ESMA met with key staff, assessed periodic information and incidents reported by CRAs, and monitored the implementation of remedial action plans.

Several CRAs have decided to establish new legal entities in the EU-27 in response to the UK's withdrawal decision, which also drives some of their important strategic and governance decisions. In this context, during 2018 ESMA monitored these developments, had regular interactions with senior management and the independent members of the Board of Directors to understand the strategic direction and governance of CRAs. ESMA also assessed the periodic information CRAs submitted and used this information to identify topics for further supervisory engagement.

For 2019, the following key priority areas were identified via the 2018 risk assessment for CRAs, namely the quality of the rating process, portfolio risk, and cybersecurity. Building on similar exercises with TRs and CCPs, ESMA will survey a subset of CRAs with the aim to assess the current state of the cybersecurity risk environment.

### **Areas of common supervisory focus for CRAs and TRs**

In addition, ESMA has worked on a number of common areas of focus for CRAs and TRs, including periodic information, internal control system, cloud computing, Brexit, and fees and ancillary services. As regards periodic information, ESMA published the new Periodic

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<sup>1</sup> [https://www.esma.europa.eu/sites/default/files/library/esma33-9-205\\_final\\_report\\_on\\_the\\_application\\_of\\_the\\_cra\\_endorsement\\_regime\\_1.pdf](https://www.esma.europa.eu/sites/default/files/library/esma33-9-205_final_report_on_the_application_of_the_cra_endorsement_regime_1.pdf)



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Information Guidelines for CRAs on 5 February 2019<sup>2</sup> and has started the preparatory work for new Guidelines for TRs. In January 2018, ESMA published a thematic report on fees charged by CRAs and TRs, identifying the key areas of concern across the CRA and TR industries with regard to the fee provisions and indicating where improvements were necessary in the existing practices. This work was further followed up with CRAs and TRs in the course of 2018. As part of its supervisory project on cloud computing, ESMA provided further guidance to TRs and CRAs in a letter detailing its views on the use of cloud computing services. Furthermore, ESMA is closely monitoring associated risks, such as data stored in non-EU locations, decision-making and governance processes, and especially the overreliance on cloud service providers.

Brexit remained a key supervisory priority in 2018, given that several registered CRAs and TRs are currently based in the UK. During 2018, as there is no assurance that a transition period will be agreed, ESMA clearly communicated to market participants that they needed to consider the scenario where a no-deal Brexit would take place on 29 March 2019. In a no-deal Brexit scenario, UK-based TRs and CRAs will lose their EU registration as of the UK's withdrawal date. As the majority of the UK-based TRs and CRAs have expressed their intention to continue providing their services in the EU-27 after Brexit, ESMA's has clearly communicated that any registered TR and CRA in the EU-27 should comply with minimum substance requirements and relevant outsourcing conditions to ensure that the post-Brexit set-up in the EU-27 is as strong as the pre-Brexit set-up in the EU.

In 2018, ESMA selected a risk management tool in order to establish an integrated platform to support the supervisory processes and their effectiveness for TRs and CRAs. Furthermore, ESMA has been exploring artificial intelligence and machine learning technologies to identify, assess, and implement use cases, tools, and techniques that could support the effectiveness and efficiency of several supervisory processes.

For 2019, ESMA has identified a number of common priority areas for CRAs and TRs. ESMA will continue its joint work on Brexit and intends to finalise its follow-up work on fees charged by TRs and CRAs. In addition, ESMA intends to further build on its work on internal control systems with the objective to introduce public guidance for this area at a later stage. ESMA will also assess the impact of using new technologies across the TR and CRA industry and the associated risks. ESMA will also continue to evaluate the effectiveness and efficiency of artificial intelligence and machine learning technologies as supervisory instruments and intends to expand the scope of potential applications for the use of these technologies in 2019.

## **TC-CCP recognition**

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<sup>2</sup> [https://www.esma.europa.eu/sites/default/files/library/esma\\_33-9-295\\_final\\_report\\_guidelines\\_on\\_the\\_submission\\_of\\_periodic\\_information\\_to\\_esma\\_by\\_credit\\_rating\\_agencies.pdf](https://www.esma.europa.eu/sites/default/files/library/esma_33-9-295_final_report_guidelines_on_the_submission_of_periodic_information_to_esma_by_credit_rating_agencies.pdf)



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Regarding TC-CCPs operating in the EU, ESMA recognises TC-CCPs initially. Subsequently each time a TC-CCP extends its range of activities and services ESMA reviews its recognition.

ESMA also assesses whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

In 2018, no new equivalence decision was made by the European Commission regarding third countries where one or more TC-CCP applicants are established, and thus no new recognition needed to be conducted.

However, the notification by the United Kingdom to leave the Union led ESMA to put an important focus on third country CCP activity in 2018, and in particular on the preparation for Brexit in a no-deal scenario.

In this respect, the European Commission communicated on 13 November on its measures to ensure continued access for EU Clearing Members and Clients to UK CCPs, and then subsequently on 19 December on the adoption of these measures. The European Commission presented the adoption of a time-limited and strictly conditional equivalence decision, which allows for a temporary recognition by ESMA, in order to ensure that there will be no systemic post-Brexit disruption to central clearing in the event of a no-deal scenario. Consequently, ESMA also issued two communications, one after each of the European Commission communications, on 23 November<sup>3</sup> and on 19 December<sup>4</sup> respectively, explaining it had begun in 2018 engaging with the European Commission, the Bank of England as the competent authority for the UK CCPs and with the UK CCPs to carry out preparatory work for the recognition process that should ensure that EU clearing members and trading venues can continue to access UK CCPs as of 29 March, 2019.

In 2019, ESMA will thus pursue the recognition process with these two categories of CCPs: firstly, the UK CCPs which will become third country CCPs on Brexit day, with a special focus on ensuring continued access for EU Clearing Members and Clients in a no-deal scenario. Secondly, the remaining TC-CCP applicants for which an equivalence decision is adopted, as well as with recognised TC-CCPs extending their activity, together with the assessment of the related clearing obligation for the relevant OTC derivatives. ESMA will negotiate and sign the corresponding MoUs with the relevant home country supervisors. Finally, ESMA will monitor that recognised TC-CCPs comply with the EMIR criteria and equivalence conditions, if applicable, on an ongoing basis.

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<sup>3</sup> <https://www.esma.europa.eu/press-news/esma-news/managing-risks-no-deal-brexit-in-area-central-clearing>

<sup>4</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-ready-review-uk-ccps%E2%80%99-and-csds%E2%80%99-recognition-applications-no-deal-brexit>



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## TC-CSD recognition

Under CSDR<sup>5</sup>, ESMA recognises TC-CSDs that provide notary or central maintenance services in relation to financial instruments constituted under the law of a Member State or that set up a branch in a Member State. A prerequisite for recognition is the adoption of an equivalence decision by the European Commission in respect of the jurisdiction of the TC-CSD. So far, there have been no equivalence decisions published by the European Commission, with the exception for the one published in respect of the UK on 19 December 2019.

In 2019, ESMA will thus pursue the recognition process for the UK CSD which will become a TC-CSD on Brexit day. ESMA negotiates and intends to sign the corresponding MoU with the Bank of England, as the competent authority for the UK CSD. Following the recognition, ESMA will monitor that the TC-CSD complies with the CSDR recognition criteria and equivalence conditions, if applicable, on an ongoing basis.

Additionally, if applicable, ESMA may need to assess the recognition applications submitted by other TC-CSDs, following the adoption by the European Commission of equivalence decisions in respect of the TC-CSDs' jurisdictions.

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<sup>5</sup> Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0909>





## Introduction

1. ESMA is one of the three European Supervisory Authorities, which, together with the ESRB and NCAs, make up the European System of Financial Supervision. The European System of Financial Supervision was established in the wake of the global financial crisis with the aim of improving the quality and consistency of supervision, strengthening the oversight of cross-border groups and establishing a single rulebook for all financial market participants within the EU.
2. ESMA's mission is to enhance investor protection and promote stable and orderly financial markets. In 2011, ESMA was designated as the single supervisor of CRAs within the EU in accordance with the provisions of CRA Regulation. The following year, ESMA was given direct responsibility for the registration and the supervision of TRs within the EU in accordance with the provisions of EMIR.
3. In accordance with ESMA's strategic orientation for 2016-2020,<sup>6</sup> ESMA is continuing to strengthen its role as a direct supervisor. The Supervision Department follows a risk-based approach for TR and CRA supervision and focuses its action in those areas where its resources may have the greatest impact.
4. In 2019, ESMA is expected to implement its new direct supervisory mandate under SFTR, which aims to increase the transparency of securities financing transactions. These transactions include repurchase arrangements, securities lending, sell/buy-back transactions, and margin lending. The SFTR will require both financial and non-financial market participants, established or operating through a branch in the EU, to report details of securities financing transactions to a TR registered or recognised by ESMA.
5. In addition, in 2019, the Securitisation Regulation will become applicable. This Regulation sets out a framework for securitisation repositories to collect relevant disclosures on securitisations. ESMA anticipates preparatory work in 2019 for the assessment of applications for registration of securitisation repositories.
6. This report provides an overview of the activities undertaken by ESMA in 2018 pursuant to the CRA Regulation and EMIR and sets out ESMA's supervision work programme for 2019.

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<sup>6</sup> ESMA/2015/935, ESMA Strategic Orientation 2016-2020, 15 June 2015, available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935\\_esma\\_strategic\\_orientation\\_2016-2020.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935_esma_strategic_orientation_2016-2020.pdf).

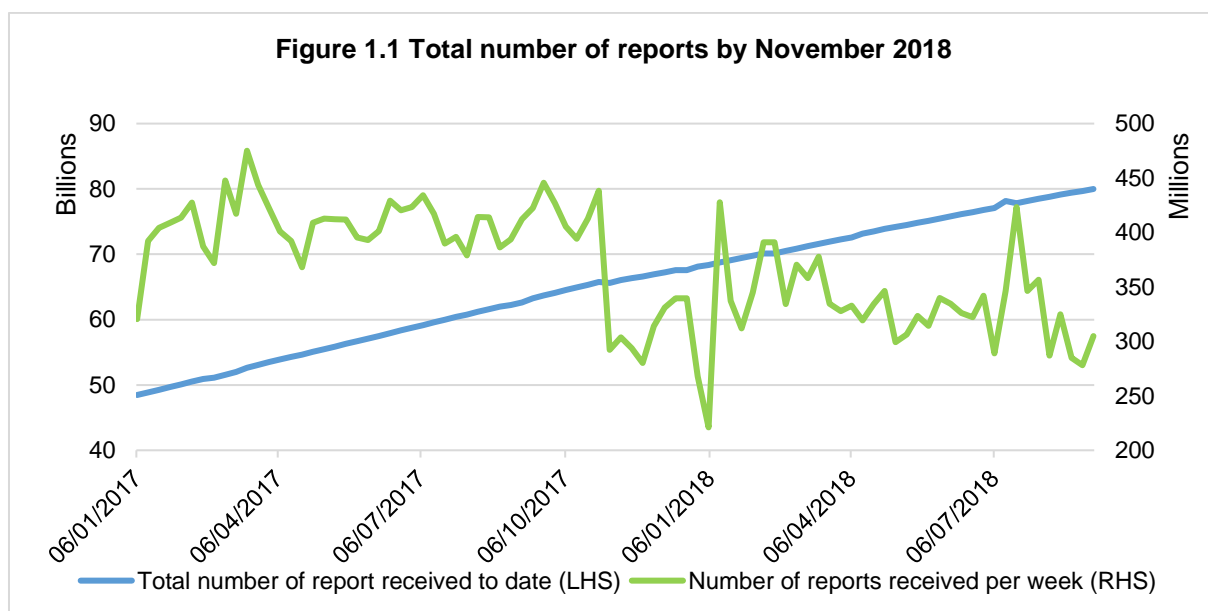


## A. Supervision of Trade Repositories and Credit Rating Agencies

### 1 Supervision of trade repositories

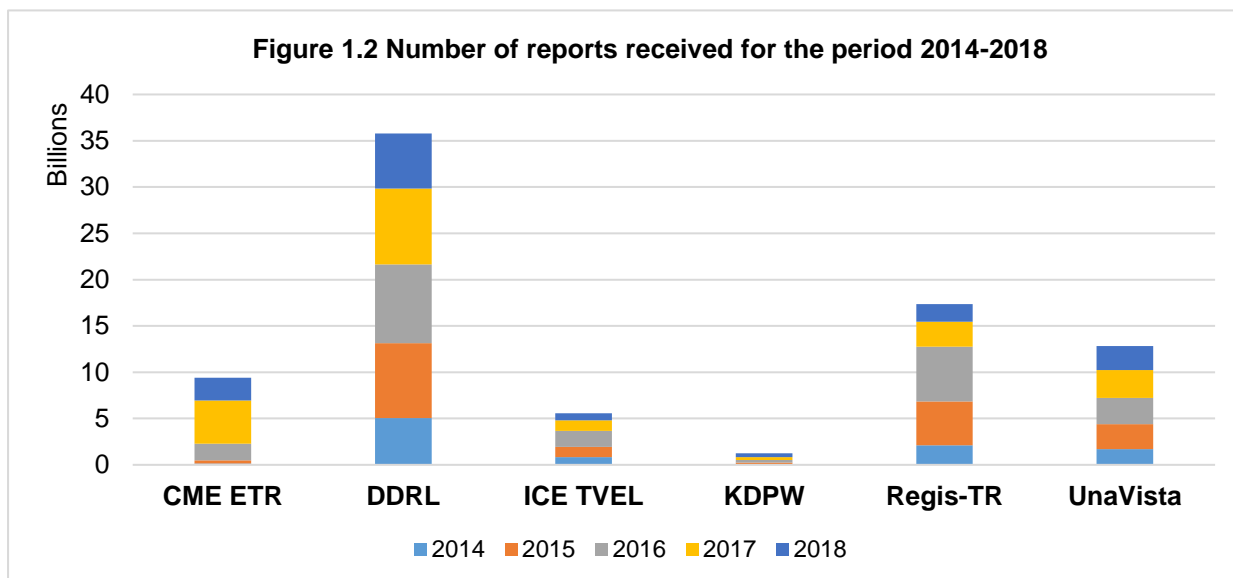
#### 1.1 Industry state of play

7. Currently, there are eight trade repositories (TRs) registered by ESMA. By November 2018, the TRs operating in the EU had collected approximately 80 billion reports in total, as illustrated in **Error! Reference source not found..1**. The reports do include not only new trades, but also modifications and other lifecycle events relating to open trades. During 2018, the level of reporting activity has stabilised at an average of approximately 390 million report submissions per week.



Source: ESMA calculations based on weekly reports provided by all TRs.

8. The distribution of market share (measured in number of reports per TR) has remained rather stable since 2017. As of October 2018, DDRL has the largest market share with 42%, followed by UnaVista with 19%, CME TR with 17%, REGIS-TR with 13%, ICE TVEL with 6% and KDPW with 3%. This is also illustrated by the number of reports received for the years 2014 to 2018, as shown in Figure 1.2.



Note: BTRL and NATR are not included in the Figure as the number of reports is very small.

Source: ESMA calculations based on weekly reports provided by all TRs.

9. As a consequence of the UK's decision to withdraw from the EU, the market structure will undergo significant changes as UK-based TRs will have to establish a presence in the EU-27 or cease operations. Many EU-27 clients of UK-based TRs will have to transfer their trades to TRs based in the EU-27. For this reason, ESMA is closely monitoring the progress of TRs in implementing the Guidelines on Portability before the UK's withdrawal from the EU-27 in early 2019. ESMA has dedicated much effort and many resources to ensure that TRs are ready for porting at the end of 2018. Other regulatory changes such as preparation for the Securities Financing Transactions Regulation (SFTR) and Securitisation Regulation (SR) will also affect TRs and their relevant stakeholders as reporting and processing technologies will have to be adjusted to the new standards (for more details on SFTR and SR please refer to Section 1.2.7).

## 1.2 Supervision activities

10. In 2018, the main topics of ESMA's supervision of TRs were data quality and access by authorities, technology trends, internal controls, governance and strategy. Where necessary, due to ad-hoc events or information received, and in line with its risk-based approach, ESMA has also reprioritised issues to focus on the highest risk areas. Examples of ad-hoc events that resulted in a reprioritisation are reported incidents or material changes that required immediate attention as they had a direct impact on availability and access to data. The following Sections provide an overview of ESMA's work in these areas.



## 1.2.1 General supervisory activities

### *Registration*

11. In 2018, two firms applied for registration in the EU-27 in response to the UK's decision to withdraw from the EU. ESMA is still assessing these applications at the time of writing this report.
12. Overall, the UK's leaving of the European Union, will result in the withdrawal of the registration of currently UK-based TRs, namely BTRL, CME TR, DDRL, ICE TVEL, and UnaVista.<sup>7</sup>

### *Day-to-day supervision*

13. ESMA dedicates a significant part of its day-to-day supervision to assessing the periodic information it receives from TRs, e.g. Board meeting minutes, compliance reports, and data-related information. TRs submit to ESMA information on a periodic basis in line with ESMA's requirements. This is an important source of information for ESMA's risk assessment. ESMA also uses the input from other stakeholders, including market participants.
14. ESMA establishes and agrees with TRs remedial action plans that set out the main actions that TRs have to perform to remedy the supervisory concerns identified during an investigation. In 2018, ESMA monitored and followed up on a remedial action plan following an investigation into data availability to regulatory authorities and data transparency of one TR. Remedial action plans are an important supervisory tool and are closely monitored by ESMA to ensure their proper implementation of mitigation actions in a timely manner.
15. Complaints relating to TRs and information received from whistle-blowers are another important source of information for ESMA as they allow ESMA to understand industry concerns and identify potential cases of non-compliance with the objectives and specific provisions of EMIR.
16. ESMA assesses all complaints and market information received and, where necessary, takes steps to address the identified concerns through its supervisory activities. In 2018, ESMA has received a number of complaints from market participants on difficulties in submitting and modifying reports and the availability and accuracy of public data.

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<sup>7</sup> See also <https://www.esma.europa.eu/press-news/esma-news/esma-asks-clients-credit-rating-agencies-and-trade-repositories-prepare-no-deal>



## 1.2.2 Data quality and data access

17. TRs play an integral role in enhancing the transparency of derivatives markets and reducing risks to financial stability by providing data to regulators and researchers. Authorities rely on TRs to provide them with access and to ensure that the quality of the data is in accordance with the regulatory requirements so that authorities can monitor the transparency of the derivatives markets and any build-ups of vulnerabilities potentially endangering the stability of the financial system, and take appropriate actions, if necessary.

### **Data quality action plan**

18. TR data quality is affected by both counterparties and TRs. Counterparties report to TRs data, which TRs then validate, store, process, and make available to authorities. Given EMIR's dual supervisory framework, whereby ESMA supervises TRs and NCAs supervise the firms who report to TRs, a joint effort is necessary to ensure that data is of high quality. Against this background, in September 2014, ESMA and NCAs jointly launched the 'Data Quality Action Plan' (DQAP) which aims at improving the quality and usability of data that is reported to and by TRs. To achieve further improvements, ESMA and authorities are continuously re-adjusting the scope of data quality activities in a collaborative effort every year since the inception of the DQAP. ESMA has worked on numerous areas to enhance TR data quality. The following paragraphs set out the areas of focus in 2018 to improve data quality.
19. In 2018, ESMA continued to monitor the data received from TRs via the data quality dashboard developed in previous years. Throughout 2018, ESMA has enhanced the monitoring tools embedded in the data quality dashboard and added new features. The dashboard is updated on a monthly basis and summarises statistics that indicate the level of data quality across different dimensions. This overview allows for the identification of data quality trends and persistent issues that cannot be detected otherwise.

### *TRACE-SFTP assessments*

20. Following the introduction of TRACE in 2016, ESMA performed three assessments regarding the completeness and alignment of the information reported through TRACE and SFTP.<sup>89</sup> The first assessment was conducted from June to September 2017, the second assessment from December 2017 to January 2018, and the third assessment from April to August 2018. These assessments included a comprehensive comparison of the trades made available to ESMA through TRACE with the trades delivered through SFTP and identified various discrepancies. ESMA communicated the results of these assessments to NCAs and followed-up with TRs which were asked to investigate the root

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<sup>8</sup> ESMA in collaboration with NCAs developed TRACE, an IT system, which allows NCAs to have a single point of access to the data stored by TRs under EMIR. This project assists authorities in using TR data more actively.

<sup>9</sup> SFTP is the pre-existing channel through which regulatory reports were provided to authorities.

causes of these discrepancies. TRs reported the following issues as root causes: (i) timing differences (e.g. misaligned reporting time generation); (ii) format-related issues (e.g. invalid ISO formats); (iii) report filtering logic (e.g. internal filtering logic not implemented correctly); (iv) XML schema (e.g. issues related to data validation); (v) legacy trades (e.g. legacy trades not passing TRACE validations); and (vi) bug fixes (e.g. remedial actions for incidents). Following each assessment, TRs implemented several fixes to remediate the identified root causes. During the assessment period, the alignment of reports provided via TRACE and SFTP has improved significantly: on average, the discrepancies between reports from both channels have been reduced to less than 1% (TR and report combination).

Box 1. Data quality action plan - TRACE-SFTP assessments in 2018		
Key activities	Key achievements	Key messages
-Two assessments of completeness and alignment of Trade State and Trade Activity reports across TRs and across channels (TRACE and SFTP) were performed within the year.	-Alignment of reports from both sources has improved significantly throughout the assessment period, reducing the discrepancies to less than 1% for most of the cases.	-Increased reliance on TRACE and SFTP. - Improved completeness of reports coming from both channels.

Note: Box 1 summarises the TRACE-SFTP assessment, which was one of the key priorities of the DQAP in 2018.

#### *Engagement with Authorities*

21. Since 2016, ESMA maintains a data quality log, which includes data quality issues reported by NCAs and other authorities using EMIR data, e.g. the ECB and the ESRB, with the objective to enhance the effective use of data and prioritise data quality issues accordingly. This standardised process prevents the replication of effort for several NCAs and other users of EMIR data that may pursue similar issues with TRs in parallel, while providing clarity to the data users as to why certain issues are getting priority. ESMA assesses and prioritises reported issues, and subsequently communicates the list of prioritised issues to NCAs first and then to other data users, to allow for increased transparency of all outstanding issues. ESMA also receives comments from NCAs on an ongoing basis regarding counterparty reporting to TRs. On average, 55 data quality issues are reported per year. In 2018, ESMA has assessed, prioritised, and addressed a wide variety of data quality issues through supervisory actions in accordance with their importance, such as issues related to access to current and historical data, errors in regulatory reports, and trade reconciliation.

#### *Data Validation*



22. Since the introduction of the validation rules in late 2015, ESMA regularly performs a re-validation of the data TRs make available to assess whether TRs have implemented the validation requirements correctly. ESMA randomly selects one day each month for which the complete daily activity reports across all TRs are re-validated.
23. ESMA has updated its re-validation tool to be in line with the revised regulatory and implementing technical standards (RTS/ITS) on reporting under Article 9 of EMIR that came into effect on 1 November 2017. Following the implementation of the RTS/ITS, the average percentage of non-compliant messages had increased as expected, but as of April 2018 a downward trend has been observed.
24. The quality of data reported to TRs also defines the usability and accuracy of the aggregate data that TRs make available publicly on their websites on a weekly basis. ESMA monitors the usability and accuracy of the public data by monitoring the evolution of the number of provided reports. In 2018, ESMA identified, amongst others, a significant increase in the total number of reports provided by one TR and requested the TR to investigate and remediate as necessary. Although the format of aggregate reports is standardised across TRs, the content still depends significantly on the contribution of all parties involved in the reporting process (namely reporting counterparties and TRs). When endorsed by the European Commission, the recently published draft technical standards on data to be made publicly available by TRs under Article 81 of EMIR will further standardise these data across TRs.

#### *Inter-TR Reconciliation*

25. Another component of the DQAP is to further improve the results of inter-TR reconciliation. The EU reporting regime requires both counterparties to a trade to report the transaction to a TR. When counterparties report to different TRs, the respective TRs are obliged to reconcile these trades between themselves. However, in practice, this process has not been that straightforward, mainly for data quality reasons.
26. In 2018, ESMA continued its work on reconciliation by monitoring the correct implementation of the pending corrective actions by TRs and by further analysing the supervisory and statistical information collected around the inter-TR reconciliation process. As of September 2018, the average pairing rate across TRs is 86% compared to an average pairing rate of 87% for November 2017 and 55% for November 2016.
27. To enhance the monitoring of the progress made in the pairing process as well as to identify additional issues hindering the reconciliation of the reported trades, ESMA has developed and uses a new tool, which simulates the pairing process of the outstanding trades across TRs and generates useful statistics, across time, on: (i) the number of paired trades (intra-TR and inter-TR); (ii) the number of trades, which are not included in the reconciliation process due to invalid identifiers (Counterparty ID, ID of the other Counterparty, and the Unique Trade Identifier); (iii) the number of submitted trades, where one of the counterparties is not an EU-based firm; (iv) the number of reports, where both



counterparties are EU-based firms, but only one counterparty has reported the trade; and (v) the number of remaining unpaired trades.

28. The new tool has enabled ESMA to increase its effectiveness in this area of supervision as it allows: (i) to identify and distinguish areas of concern between TRs and counterparty reporting; (ii) to track progress across TRs and across the time of the pairing process; and (iii) to record the evolution of the population of non-pairable trades due to non-Legal Entity Identifiers (LEIs) or non-EEA.

#### *Data Access*

29. As of October 2018, TRs reported on behalf of approximately 6,000 direct clients. This number includes clients that, as third parties, report on behalf of other counterparties and firms. The latter only have the right to view data reported on their behalf. In total, there are approximately 624,415 counterparties whose trades are reported to TRs.
30. Some authorities are not yet using their right to access and use TR data. ESMA has monitored the progress on access to TRs by authorities throughout 2018. As of November 2018, 51 authorities, including NCAs and central banks, had access to at least one TR.

#### *Portability*

31. As part of its ongoing monitoring activities in the context of the implementation of the Guidelines on Portability, ESMA undertook a review of the quality of derivative data across TRs. ESMA has observed that there are data quality variations across TRs as not all trades reported meet the revised RTS/ITS. To ensure that trades, which are to be ported from one TR to another, are in line with the revised RTS/ITS reporting requirements, reporting counterparties will need to upgrade these to meet the revised RTS/ITS reporting requirements.

#### *Other areas affected by data quality*

32. It is important to note, that data quality may not only affect TRs' compliance with EMIR requirements, but it may also have other consequences, such as on the level of the supervisory fees that TRs annually pay to ESMA. The number of trades reported to the TR during the previous year and the number of outstanding trades on 31 December of the previous year are two of the three parameters that are equally considered when allocating the annual supervisory fees for TRs. In 2018, ESMA observed that some TRs did not put the necessary effort into providing the relevant data in a timely manner to ESMA for establishing annual supervisory fees and ESMA needed to follow-up with the TRs concerned.





### 1.2.3 Governance and Strategy

33. In response to the UK's decision to withdraw from the EU-27, several TRs have decided to establish new legal entities in the EU-27, which also drives some of their important strategic and governance-related decisions.
34. During 2018, ESMA continued to actively engage with TRs to understand and assess their strategic direction and governance, particularly in the context of the UK's decision to withdraw from the EU and the related changes. Some TRs delayed their strategic decisions in this regard as they finalised their planning later than other TRs. ESMA had exchanges on both strategic and operational matters with key staff, senior management, and the Board of Directors. In general, during 2018, ESMA intensified its dialogue with supervised firms in line with their risk profile. In addition, ESMA has been continuously monitoring the strategy and governance of TRs by assessing the periodic information TRs submit.

#### *Material changes*

35. TRs are required to notify ESMA of any material changes to the conditions of registration. These notifications can pertain to a wide variety of topics, such as personnel, changes in the compliance function, appointment of new Board members, launch of new services, or infrastructure-related changes.
36. ESMA thoroughly assesses these notifications to ensure that the TR still meets the conditions under which it was registered. If ESMA is concerned that the TR may no longer meet the conditions for registration, ESMA may inform the TR that it needs to reconsider the aspects of the change that pose a concern or re-apply for registration. It is, therefore, very important that TRs pro-actively discuss complicated organisational changes or transactions at their early stages with ESMA and provide all relevant information.
37. In 2018, ESMA has assessed a wide variety of notifications, including changes or upgrades of TR application software and/or the related technical infrastructure components, changes in the group structure of firms with which the TR has close links, and a notification pertaining to the cessation of business. On average, ESMA receives approximately 37 notifications of material changes by TRs within a calendar year.

#### *Competition and strategic directions*

38. Following the decision of the UK to withdraw from the EU, UK-based TRs face registration withdrawal as an EU-registered TR or need to establish new legal entities in the EU-27. As not all UK-based TRs have applied for registration in the EU-27, ESMA expects changes in terms of market share within the next months when EU-27 counterparties migrate to TRs based in the EU-27. In addition, through the implementation of the Guidelines on Portability, market participants will be able to transfer their transactions from one TR to another, which is expected to foster competition in the TR sector.





39. In terms of strategic direction, TRs continue to explore different possibilities to add value to their core services offered under EMIR or expand their businesses in new directions. For example, several TRs have expressed their interest to apply for registration under SFTR. Furthermore, several TRs plan to offer ancillary services, e.g. translation services for regulatory reporting or other commercial services based on data reported to TRs. Certain ancillary services using confidential data of TR participants that TRs plan to offer raise concerns from a supervisory perspective as they may endanger EMIR confidentiality requirements and other related EMIR requirements.

#### *Resources*

40. In 2018, some TRs continued to progress towards the enhancement of their resources in terms of staff, costs and technological solutions, while for others this remains a supervisory concern. It is important to note that TRs need to have sufficient and appropriate resources to fulfil their main obligations under EMIR. The level of resources dedicated to the TR business remains an area of concern for some TRs especially regarding the compliance function and IT-related functions, particularly in light of upcoming regulatory changes, such as SFTR and SR (for more details on SFTR and SR please refer to Section 1.2.7). ESMA engaged with TRs throughout periods of staff turnover to ensure that TRs retained sufficient resources and suitably qualified staff. ESMA expects TRs to increase resources if they choose to expand their business into new reporting regimes.
41. In 2018, ESMA continued to regularly monitor TRs' financial situation based on the audited annual financial statements and interim financial statements submitted. The analysis suggests that TRs have sufficient buffers for operational costs (at least for six months) in case they would find themselves in a critical situation.

#### **1.2.4 Internal controls**

42. As part of the wider analysis of leading internal control practices and their applicability to the TR industry, ESMA has engaged and interacted more actively with the Internal Audit (IA) function of selected TRs. A clearer view of the organisational structure of the IA functions across TRs, the manner in which they prioritise their work, the way the IA assessments are conducted and their respective results, enabled ESMA to adjust the focus of its supervisory activities.
43. As regards the effectiveness of internal controls, ESMA has identified that some TRs have not established adequate and effective evaluation and monitoring activities within their internal control framework. In this context, ESMA has found issues related to a lack of oversight by the Board of Directors regarding compliance monitoring, inadequate assessment mechanisms that do not allow for the proper identification of issues, and cases where the group-driven IA function does not focus appropriately on the TR business. To aid TRs in establishing an adequate internal control system, ESMA will



communicate its views as to what constitutes an effective internal control system for firms through guidance in 2019 (see Section 3).

44. Following a letter sent to all TRs in 2017 where ESMA expressed its concerns regarding the role of the compliance function and outlined a set of principles to address these concerns, ESMA continued to closely monitor this area in 2018. Although ESMA observed some progress in this area for certain TRs over the past year, ESMA noted that one TR did not have specific internal controls for the compliance function in place, some TRs still have not implemented clear reporting lines of the compliance function to the Board of Directors, and certain TRs need to further instil a compliance-oriented culture.

### 1.2.5 IT systems design and operation

45. TRs are technology-based market infrastructures and the robustness and reliability of their IT systems is an important driver of their ability to perform their duties under EMIR. Considering the volumes of submissions that TRs receive on a weekly basis (390 million on average) and the timeframes that must be respected (the data needs to be available to regulators in a timely manner), ESMA believes that increased automation of all or most parts of the process is necessary and that the reliance on the various IT system components for complete and accurate processing is essential.
46. Following the implementation of the new RTS/ITS in November 2017, ESMA observed an increase of incidents for several TRs. In this respect, ESMA allocated time and effort to supervise the effective identification of root causes, the prompt remediation, and the strengthening of the respective control environment.
47. In addition, ESMA focused on the internal control activities performed by selected TRs in the context of their system development lifecycle. More specifically, monitoring activities were directed towards TRs' sub-processes for managing software changes and software quality assurance and testing. Controls and practices applied in these areas have a direct effect on the completeness and accuracy of the data TRs make available to authorities or on the early identification of potential issues before they affect production systems.
48. Following the issuance of the Guidelines on Portability, which cover the transfer of data both at the request of a counterparty and due to a TR registration withdrawal, TRs did not manage to meet the implementation deadline for enabling porting as they: (i) prioritised the transition to the new RTS on 1 November 2017; and (ii) faced several implementation issues related to each TR's system architecture compatibility, data quality variations as well as aspects of inter-TR coordination.
49. To facilitate the implementation of the Guidelines on Portability and support TRs in their joined responsibility of overcoming the IT- and infrastructure-related difficulties, ESMA hosted a roundtable on 16 May 2018 to identify major problems. Following the roundtable and taking into account the considerations TRs brought forward, ESMA provided further



communications as to the identified implementation issues and engaged repeatedly with TRs throughout the year to accelerate compliance with the respective Guidelines.

### 1.2.6 Information security and cybersecurity

50. Given the high risks related to cybersecurity, ESMA is monitoring the cybersecurity threat landscape and any information on security incidents TRs report to ESMA on an on-going basis. Following the guidance ESMA provided to TRs regarding cloud computing in 2018, ESMA has been closely following up with selected TRs as regards their cybersecurity policies and practices including those related to cloud computing.
51. As regards the adequacy and effectiveness of information security and cybersecurity controls, ESMA observed issues related to access controls, information security incident management, information security risk assessment, as well as business continuity management. In addition, ESMA has concerns regarding the adequacy and effectiveness of information security controls in the system development life cycle process and in outsourcing relationships, including in the use of cloud computing service providers. ESMA also followed-up on important information security incidents that resulted in confidentiality breaches or in loss of availability and integrity of EMIR data.

### 1.2.7 Future ESMA TR-related mandates

#### *Securities Financing Transaction Regulation*

52. Transactions referred to as Securities Financing Transactions (SFTs) include repurchase agreements, securities lending, sell/buy-back transactions, and margin lending. The SFTR will require both financial and non-financial market participants, established or operating through a branch in the EU, to report details of SFTs to a TR registered or recognised by ESMA. These details will include the relevant terms of the SFT, the composition and characteristics of the collateral, the information on margins for cleared SFTs as well as the information on the reuse of collateral, cash reinvestment and funding sources.
53. In December 2018, the European Commission endorsed the RTS/ITS implementing the SFTR. Firms will be required to start reporting their SFTs to TRs 12 months after publication of the delegated and implementing acts in the Official Journal of the EU. The reporting obligation will be phased-in over nine months.
54. ESMA expects that several of the TRs currently registered under EMIR will apply for an extension of registration for SFTR. These applications for SFTR will be a key supervisory priority during 2019. Considering the anticipated applications for registration, ESMA is going through the relevant preparatory work required and is prepared to receive such applications for registration.



### *Securitisation Regulation*

55. ESMA has been designated as the supervisor of securitisation repositories, as it has already developed tools and analytical experience from the supervision of TRs and the analysis of EMIR data.
56. The SR provides a general framework for securitisation and establishes a specific framework for simple, transparent, and standardised (STS) securitisation. Under the SR, ESMA has defined the reporting requirements for several features of securitisations, such as details of their underlying exposures, details of the securitisation structure itself, and information on the securitisation cash flows.
57. ESMA published the final report containing the relevant draft technical standards in the second half of 2018. These draft technical standards are expected to be endorsed in 2019.<sup>10</sup>
58. ESMA expects that some of the TRs currently registered under EMIR will apply for an extension of registration for SR. These applications for SR will be a key supervisory priority during 2019. Considering the anticipated applications for registration, ESMA is going through the relevant preparatory work required and is prepared to receive such applications for registration.

## **2 Supervision of credit rating agencies**

### **2.1 Industry state of play**

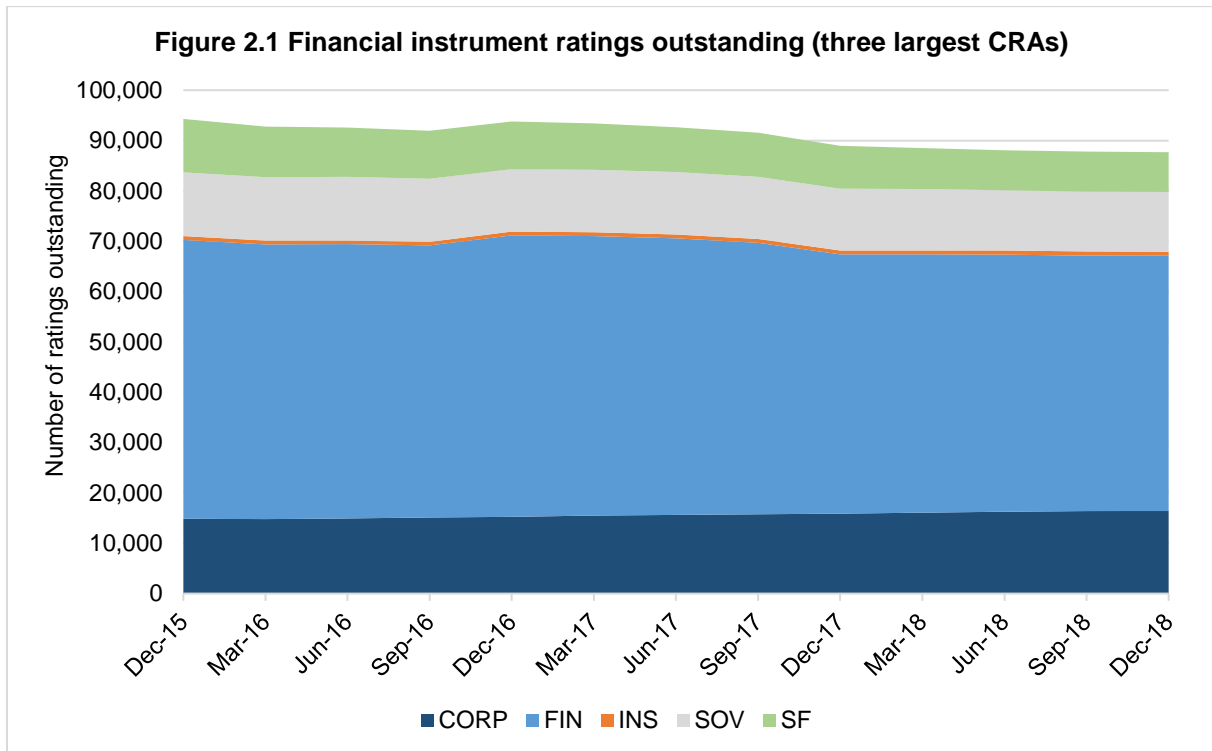
#### 2.1.1 Competitive dynamics and trends

59. During 2018, ESMA registered four new credit rating agencies (CRAs). The number of CRAs registered in the EU amounts to 27 registered CRAs; there are also four certified CRAs. The CRA industry remains concentrated around three large players.<sup>11</sup>
60. ESMA observes that the capacity to generate revenue and the overall operating margins are significant for the largest CRAs operating globally. The small- and medium-sized (SM) CRAs do not have the same market position as the three largest CRAs and as a result do not have similar operating margins.

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<sup>10</sup>See <https://www.esma.europa.eu/policy-activities/securitisation>

<sup>11</sup> See [https://www.esma.europa.eu/sites/default/files/library/cra\\_market\\_share\\_calculation\\_2018.pdf](https://www.esma.europa.eu/sites/default/files/library/cra_market_share_calculation_2018.pdf)

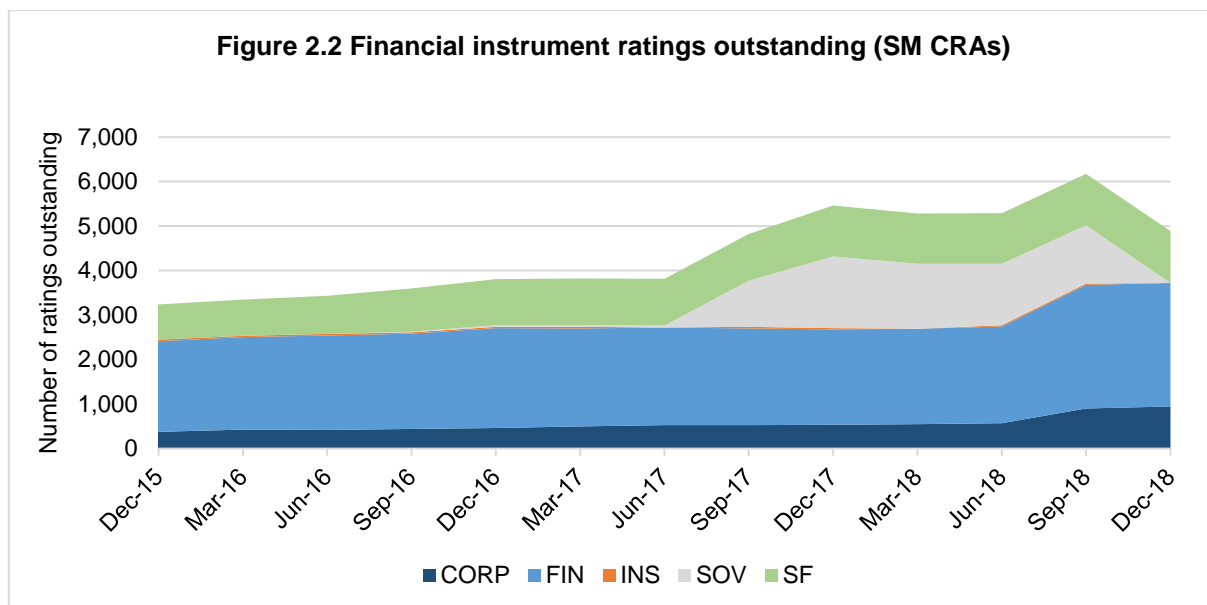


**Note:** The abbreviations above correspond to the following: “CORP” for corporate financial credit rating, “FIN” for financial institutions credit rating (including covered bonds), “INS” for insurance institutions credit rating, “SOV” for sovereign credit rating, and “SF” for structured finance credit rating. The credit ratings shown in this figure refer to EU credit ratings only.

**Source:** ESMA RADAR database<sup>12</sup>

61. As can be seen in Figure 2.1 above, the number of outstanding European financial instrument credit ratings issued by the three largest CRAs has shown a moderately decreasing trend for financial institutions and structured finance credit ratings since 2015. For corporate institutions, insurance institutions, and sovereigns, the credit ratings issued by the three largest CRAs have remained rather stable.
62. In contrast, the number of outstanding European financial instrument credit ratings issued by the SM CRAs is overall much lower but shows an increase over the past three years for all asset classes, except for structured finance credit ratings. The number for structured finance credit ratings remains rather stable since 2015, as shown in Figure 2.2 below.

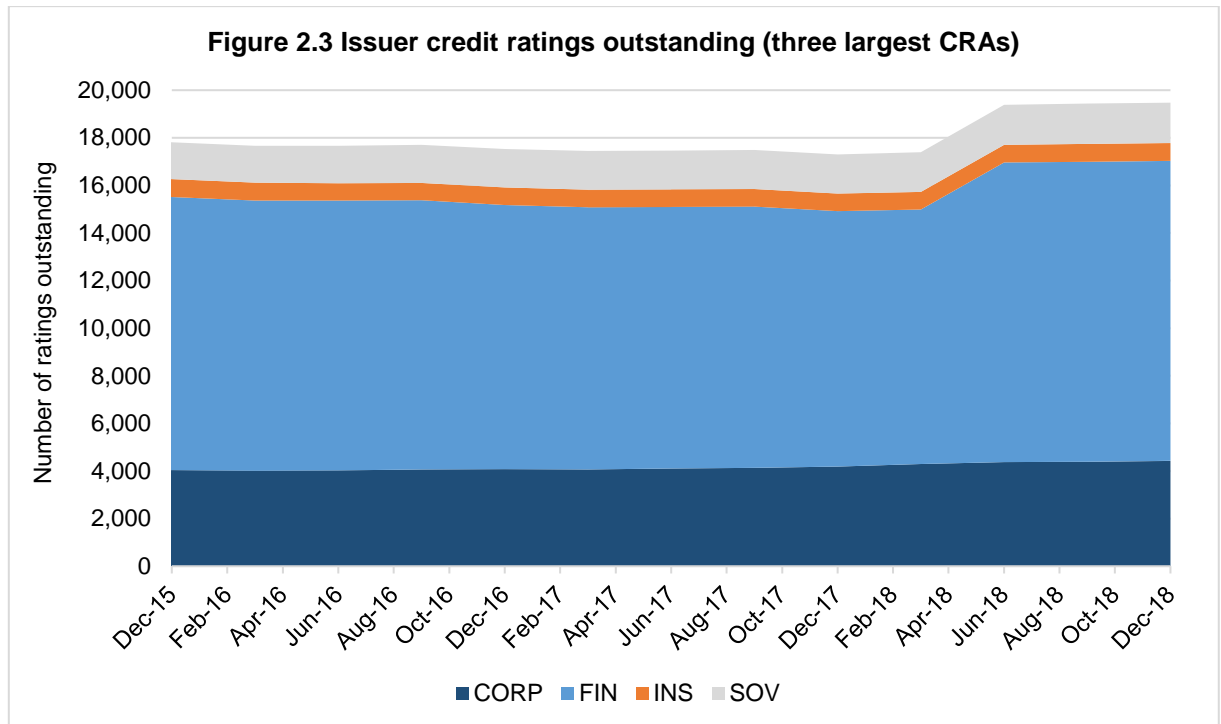
<sup>12</sup> As part of its disclosure requirements, ESMA provides a unique set of data in the form of a central repository (CEREP) containing CRAs’ rating activity statistics and rating performance statistics (see <https://cerp.esma.europa.eu/cerp-web/homePage/displayAbout.xhtml>).



Note: The abbreviations above correspond to the following: “CORP” for corporate financial credit rating, “FIN” for financial institutions credit rating (including covered bonds), “INS” for insurance institutions credit rating, “SOV” for sovereign credit rating, and “SF” for structured finance credit rating. The credit ratings shown in this figure refer to EU credit ratings only.

Source: ESMA RADAR database

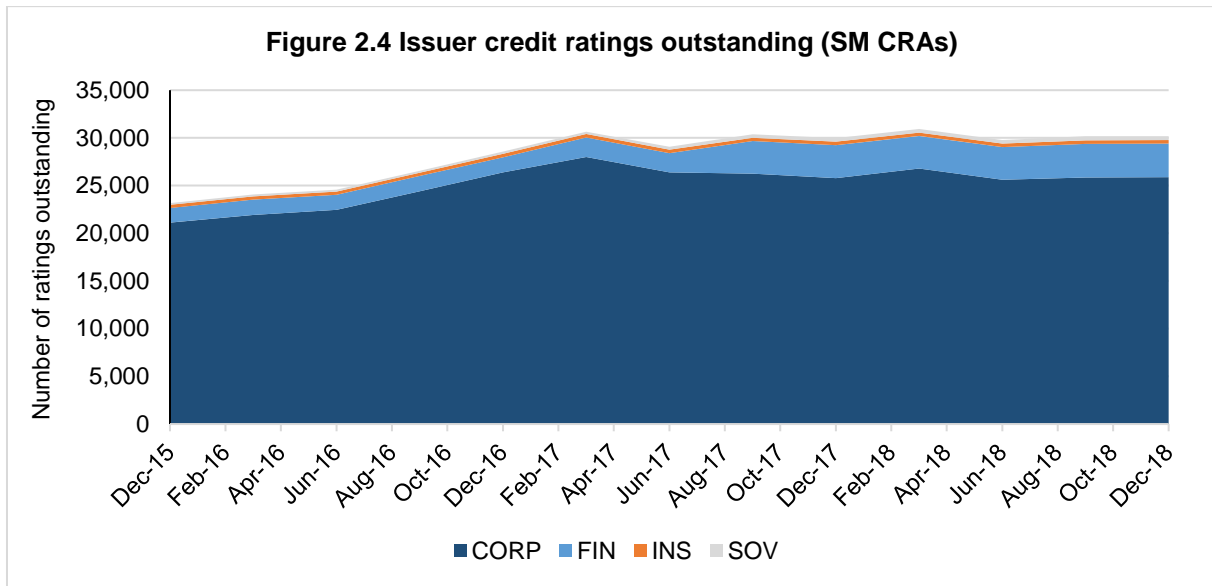
63. Turning to Figure 2.3, the number of outstanding European issuer credit ratings issued by the three largest CRAs has remained rather stable over the past years for all asset classes. However, since the beginning of 2018, ESMA has observed a noticeable increase for all asset classes, in particular for financial institutions credit ratings. The increase in financial institutions credit ratings is of a technical nature as new rating types are being created.



Note: The abbreviations above correspond to the following: “CORP” for corporate financial credit rating, “FIN” for financial institutions credit rating (including covered bonds), “INS” for insurance institutions credit rating, and “SOV” for sovereign credit rating. The credit ratings shown in this figure refer to EU credit ratings only.

Source: ESMA RADAR database

64. As regards SM CRAs, the number of outstanding issuer credit ratings has remained stable for corporate institution and insurance institution credit ratings throughout 2018, as shown in Figure 2.4. In contrast, an increase can be observed for the asset classes of financial institutions and sovereigns.



Note: The abbreviations above correspond to the following: “CORP” for corporate financial credit rating, “FIN” for financial institutions credit rating (including covered bonds), “INS” for insurance institutions credit rating, and “SOV” for sovereign credit rating. The credit ratings shown in this figure refer to EU credit ratings only.

Source: ESMA RADAR database

## 2.1.2 Endorsement

65. Endorsement is a regime under the CRA Regulation, which allows credit ratings issued by a third country CRA, and endorsed by an EU CRA, to be used for regulatory purposes in the EU. Currently, more than two thirds of the credit ratings that can be used for regulatory purposes in the EU are introduced through the endorsement regime. Endorsement is used by the largest CRAs operating in the EU. Nearly all endorsed credit ratings relate to non-EU issuers and financial instruments.
66. In November 2017, ESMA published a revision of its Guidelines on Endorsement that were first issued in 2011.<sup>13,14</sup> The updated Guidelines aimed to achieve three separate objectives. Firstly, it was necessary to reflect a range of new requirements of the CRA

<sup>13</sup> Final Report Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation No 1060/2009 (18 May 2011 | ESMA/2011/139), available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/esma\\_2011\\_139.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma_2011_139.pdf).

<sup>14</sup> Final Report Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (17 November 2017 | ESMA33-9-205) [https://www.esma.europa.eu/sites/default/files/library/esma33-9-205\\_final\\_report\\_on\\_the\\_application\\_of\\_the\\_cra\\_endorsement\\_regime\\_1.pdf](https://www.esma.europa.eu/sites/default/files/library/esma33-9-205_final_report_on_the_application_of_the_cra_endorsement_regime_1.pdf).



Regulation 3 that became applicable as of 1 July 2018<sup>15</sup>. Secondly, ESMA had identified through its supervisory experience the need to provide further clarity regarding a number of issues which were not or only partially addressed in the 2011 Guidelines, e.g. the notion of ‘objective reasons’ and ESMA’s ability to monitor and assess the compliance of a third country CRA.<sup>16,17</sup> Thirdly, in light of the importance of credit ratings produced in third countries and used in the EU, it was important for ESMA to ensure that endorsed credit ratings meet the same high standards as credit ratings issued in the EU.

67. The updated Guidelines provided an important clarification regarding the obligation of an endorsing CRA to verify and demonstrate compliance to ESMA of the conduct of the third country CRA that elaborated the endorsed credit rating.<sup>18</sup> In this regard, the updated Guidelines clarified that ESMA will not consider this obligation to be automatically fulfilled when a third country CRA is based in a jurisdiction whose legal and supervisory framework has been positively assessed by ESMA. Instead, an endorsing CRA should verify that the third country CRA fulfils the relevant requirements of the CRA Regulation directly or, where it does not, that it has established and adheres to alternative internal requirements that are at least as stringent.<sup>19</sup>
68. On the request of a number of CRAs, ESMA published a supplement to these updated Guidelines on Endorsement in July 2018.<sup>20</sup> This supplement sets out the general principles which ESMA relies on for assessing whether an alternative internal requirement which a third country CRA has established and adheres to<sup>21</sup> can be considered “as stringent as” the requirement set out in the CRA Regulation. It also contains a non-exhaustive list of alternative requirements proposed by one or more CRAs which ESMA considers to pass this test.

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<sup>15</sup> 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 regulation (CRA 3, available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013R0462>) entered into force for the purposes of endorsement and equivalence on 1 June 2018. In light of these new requirements, ESMA was required to update its methodological framework for assessing the supervisory and legal framework of a third country for the purposes of equivalence and/or endorsement.

<sup>16</sup> Article 4(3)(e) of the CRA Regulation.

<sup>17</sup> Article 4(3)(c) and (d) of the CRA Regulation.

<sup>18</sup> As per Article 4(3)(b) of the CRA Regulation, an endorsing CRA should verify and be able to demonstrate on an ongoing basis that the conduct of the credit rating activities by the third country CRA resulting in the issuing of the credit rating to be endorsed fulfils requirements which are at least as stringent as the requirements set out in Articles 6 to 12 and Annex I, with the exception of Articles 6a, 6b, 8a, 8b, 8c and 11a, point (ba) of point 3 and points 3a and 3b of Section B of Annex I of the CRA Regulation.

<sup>19</sup> Articles 6 to 12 and Annex I, with the exception of Articles 6a, 6b, 8a, 8b, 8c and 11a, point (ba) of point 3 and points 3a and 3b of Section B of Annex I of the CRA Regulation (c.f. Article 4(3)(b) of the CRA Regulation).

<sup>20</sup> Final Report Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation – supplementary guidance on how to assess if a requirement is “as stringent as” the requirements set out in CRAR (18 July 2018 | ESMA33-9-246) [https://www.esma.europa.eu/sites/default/files/library/esma33-9-246\\_final\\_report\\_supplementary\\_guidelines\\_on\\_endorsement.pdf](https://www.esma.europa.eu/sites/default/files/library/esma33-9-246_final_report_supplementary_guidelines_on_endorsement.pdf).

<sup>21</sup> Articles 6 to 12 and Annex I, with the exception of Articles 6a, 6b, 8a, 8b, 8c and 11a, point (ba) of point 3 and points 3a and 3b of Section B of Annex I of the CRA Regulation (c.f. Article 4(3)(b) of CRAR).



69. The updated Endorsement Guidelines, including the supplement published in July 2018, took effect on 1 January 2019.

## 2.2 Supervision activities

70. In 2018, the main topics of ESMA's supervision of CRAs were quality of credit ratings, IT, internal controls, and strategy and governance. Within these topics, ESMA identified a number of key areas of focus. The following Section provides an overview of general supervisory activities and of the work ESMA performed with regard to the CRAs' rating methodologies and rating process, IT, internal controls, strategy and governance, and enforcement.

### 2.2.1 General supervisory activities

#### *Registration*

71. During 2018, ESMA received six applications for registration as a CRA. At the time of publication of this report, ESMA approved three applications while the assessment of the other three applications is still ongoing. ESMA also approved one application received in late 2017. Furthermore, ESMA withdrew the registration of one CRA, following the CRA's official notification of its intention to renounce its registration.<sup>22</sup> The total number of CRAs amounts to 27 registered CRAs and 4 certified CRAs in the EU as of 31 December 2018.
72. As a result of the UK's decision to withdraw from the EU, UK-based CRAs needed to establish CRAs based in the EU-27, if they want to continue to serve the EU market. This led to an increased number of applications for registration, and ESMA dedicated significant resources to ensure the timely and sound assessment of these applications. Overall, the UK's withdrawal decision will result in the withdrawal of registration of UK-based CRAs, namely AM Best Europe-Rating Services Ltd.; DBRS Ratings Limited; Fitch Ratings Limited; Fitch Ratings CIS Limited; Moody's Investors Service Ltd; Moody's Investors Service EMEA Ltd; The Economist Intelligence Unit Ltd.<sup>23</sup> The three largest CRAs, which are also affected by Brexit, will continue to operate in the EU-27 through legal entities previously established in the EU-27.<sup>24</sup>

#### *Day-to-day supervision*

73. ESMA dedicates a significant part of its day-to-day supervision to assessing the periodic information it receives from CRAs, e.g. Board meeting minutes, compliance reports, and

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<sup>22</sup> <https://www.esma.europa.eu/press-news/esma-news/spmws-cra-registration-withdrawn>

<sup>23</sup> See also <https://www.esma.europa.eu/press-news/esma-news/esma-asks-clients-credit-rating-agencies-and-trade-repositories-prepare-no-deal>

<sup>24</sup> In 2018, S&P Global Ratings Italy S.r.l, Standard and Poor's Credit Market Services Europe Limited, and S&P Global Ratings France SAS merged into S&P Global Ratings Europe Limited.



data-related information. CRAs submit to ESMA information on a periodic basis as provided for in the Periodic Information Guidelines.<sup>25</sup> This is an important source of information for ESMA's risk assessment. ESMA also uses the input from other stakeholders, including issuers and investors.

74. ESMA establishes and agrees with CRAs remedial action plans that set out the main actions that CRAs have to perform to remedy the supervisory concerns identified during an investigation. In 2018, ESMA monitored and followed up on several remedial action plans following investigations into the rating process of a number of CRAs, an investigation into potential conflicts of interest caused by a CRA's shareholders, and an investigation into a CRA's rating model. Remedial action plans are an important supervisory tool and are closely monitored by ESMA to ensure their proper implementation in a timely manner (for more details on remedial actions please refer to Section 2.2.2).
75. Complaints relating to CRAs and information received from whistle-blowers are another important source of information for ESMA as they allow ESMA to understand industry concerns and identify potential cases of non-compliance with the objectives and specific provisions of the CRA Regulation. In addition, ESMA takes the information it receives into account in its risk assessment.
76. For these reasons, ESMA assesses all complaints and market information received and, where necessary, takes steps to address the identified concerns through its supervisory activities. In 2018, ESMA has received a number of complaints from market participants on disclosure requirements and on the misapplication of rating methodologies.

#### *Perimeter*

77. Firms who aim to issue credit ratings in the EU need to be registered with ESMA. To ensure a level playing field, ESMA performs perimeter assessments to identify market participants issuing credit ratings without registration. In this context, ESMA uses a variety of information sources, including market participants, NCAs, and its own assessments (e.g. periodic internet sweeps), to identify firms potentially providing credit rating activities without registration. Where necessary, firms issuing credit ratings without registration may be referred to ESMA's enforcement team.
78. Throughout 2018, ESMA interacted with and assessed information provided by numerous firms to identify whether their activities fall within the scope of the CRA Regulation. As a result of such interactions, several firms have taken the necessary action to ensure compliance.

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<sup>25</sup> <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609.pdf>



79. ESMA notes that firms that: (i) are legal persons established in the EU; and (ii) issue, on a professional basis, credit ratings (as defined by the CRA Regulation), which are disclosed publicly or distributed by subscription, should apply to ESMA for registration. ESMA uses this definition in its perimeter activities to maintain a consistent approach when assessing such cases.
80. Following the perimeter assessments conducted in previous years, in 2018, ESMA fined five banks, which were found to issue credit ratings without registration (see also Section 2.2.5). In this respect, ESMA found that the products issued by these banks fell within the scope of the CRA Regulation. ESMA encourages market participants to refer to the respective Decisions of ESMA's Board of Supervisors, which provide further information on the cases and on ESMA's assessments of the scope of the CRA Regulation.<sup>26</sup>

#### *International cooperation*

81. To achieve its supervisory objectives, and due to the global nature of the larger CRAs' operations, supervisory cooperation with other supervisory authorities is a key aspect of ESMA's supervision of CRAs. Therefore, ESMA is actively participating in the global supervisory colleges, which consist of ESMA and the main CRA regulators, which supervise the three largest and internationally operating CRAs outside the EU. The supervisory colleges facilitate information-sharing and cooperation between supervisors operating in different jurisdictions.
82. During 2018, international coordination of the supervision of the three largest CRAs has been further enhanced. The main CRA supervisory authorities have jointly discussed the following topics with supervised firms: their strategy, organisational changes and challenges, the rating process, the use of new technologies, and cybersecurity. Furthermore, ESMA also maintained bilateral interactions with supervisors from third countries on smaller, globally operating, CRAs.

### 2.2.2 Rating methodologies and rating process

83. One of the main objectives of the CRA Regulation is to ensure that credit ratings are independent, objective, and of good quality. As set out in the 2018 work programme, quality of credit ratings has been one of the focus areas of ESMA's supervisory activities

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<sup>26</sup> The respective Decisions of the ESMA Board of Supervisors are available at:

[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1153\\_final\\_bos\\_decision\\_-\\_cra\\_2-2017\\_-\\_seb.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1153_final_bos_decision_-_cra_2-2017_-_seb.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1152\\_final\\_bos\\_decision-cra\\_2-2017-swedbank.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1152_final_bos_decision-cra_2-2017-swedbank.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1150\\_final\\_bos\\_decision-cra\\_2-2017-nordea.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1150_final_bos_decision-cra_2-2017-nordea.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1147\\_final\\_bos\\_decision-cra\\_2-2017-handelsbanken.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1147_final_bos_decision-cra_2-2017-handelsbanken.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1145\\_final\\_bos\\_decision-cra\\_2-2017-danske.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1145_final_bos_decision-cra_2-2017-danske.pdf)



regarding CRAs for 2018. ESMA has worked on numerous areas to enhance the quality of credit ratings.

84. In addition to a number of dedicated investigations and remedial action plans agreed with certain CRAs (as described below), ESMA has also followed-up on its thematic work into validation practices within CRAs and analyst rotation.
85. ESMA also continuously monitors credit rating trends and developments in credit ratings through the information CRAs report. To this end, ESMA uses a range of supervisory tools and statistical methods, e.g. Accuracy Ratio, to examine the quality and accuracy of credit ratings. Where ESMA finds outliers or unexpected patterns in the data, it will gather more information and follow-up with the CRA, if necessary. ESMA has done so on a number of occasions in 2018.

#### *General*

86. During 2018, ESMA launched dedicated supervisory work-streams related to the quality of credit ratings in various CRAs. Peer comparison is a useful tool to identify different approaches and good practices, which in turn support the establishment of consistent approaches across the industry, e.g. in how CRAs have implemented the credit rating surveillance process.
87. In the context of the analyst rotation requirements, consistent application of regulatory requirements across the industry is necessary to maintain the quality of credit ratings and prevent conflicts of interest. Following the publication of ESMA's Q&A on analyst rotation requirements in response to CRAs' inconsistent application of these requirements, during 2018 ESMA conducted follow-up supervisory work to ensure that the CRAs' revised rotation arrangements are in line with the CRA Regulation requirements and ESMA's Q&A on analyst rotation requirements.<sup>27</sup>

#### *Quality of the credit rating process*

88. Methodologies are at the heart of the rating process and their quality is essential to ensure the consistency and quality of the credit ratings. Rating methodologies should guide the analytical judgment to ensure that the analysts' assessment is thorough, consistent, and complete. To this end, methodologies should be rigorous, systematic, continuous, and subject to validation. In addition, given the importance of rating methodologies, the process to establish a new rating methodology or introduce changes to existing rating methodologies should adhere to the transparency, independence, and soundness requirements of the CRA Regulation.

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<sup>27</sup>[https://www.esma.europa.eu/sites/default/files/library/questions\\_and\\_answers\\_on\\_the\\_implementation\\_of\\_the\\_regulation\\_eu\\_no\\_463\\_2013\\_on\\_credit\\_rating\\_agencies.pdf](https://www.esma.europa.eu/sites/default/files/library/questions_and_answers_on_the_implementation_of_the_regulation_eu_no_463_2013_on_credit_rating_agencies.pdf)

89. CRAs need to implement processes to meet all the requirements of the CRA Regulation and ensure that high-quality credit analysis is supported. To achieve this, CRAs should: (i) use reliable information of high quality; (ii) continuously monitor all credit rating factors; (iii) minimise conflicts of interest; and (iv) ensure that analytical functions are staffed with sufficient and expert resources. Finally, CRAs need to ensure that an appropriate level of transparency with regard to the underlying analysis and process used to produce credit ratings is maintained.
90. Against this background, in 2018, ESMA has engaged in several activities aimed at enhancing the rating process and the rating methodology framework of CRAs.
91. Firstly, ESMA has engaged with a number of CRAs to address its concerns regarding the CRAs' rating/surveillance processes.
92. From the CRA Regulation's perspective, there is no differentiation between rating monitoring and rating assignment. However, while CRAs may implement rating processes as deemed appropriate, they need to apply certain key controls to safeguard the quality of the underlying analysis. The following key controls should be applied during the mandatory semi-annual or annual review of credit ratings: (i) all key rating factors/rating assumptions should be reviewed as part of the periodic review; (ii) key conflicts of interest controls should be applied (e.g. rotation of analysts, conflicts of interest checks); (iii) the semi-annual or annual reviews should be approved by staff with the adequate degree of seniority. Furthermore, as a best practice and to ensure transparency to the markets, CRAs should publish a press release at conclusion of the semi-annual or annual review disclosing the outcome of the review including the related rationale; the rated firms should be given the opportunity to verify the factual accuracy of the relevant information.
93. Furthermore, in 2018, ESMA conducted several targeted investigations into the rating processes and the rating methodology framework of CRAs.
94. In two of these investigations, ESMA assessed the quality and accuracy of credit ratings issued by two CRAs. Areas of focus were, among others: (i) the rating methodologies, models, and key rating assumptions; (ii) the process to issue, monitor, and review credit ratings and related controls; and (iii) the resources employed in the different phases of the rating process. ESMA assessed the above with specific attention to the business models of the CRAs, which issue primarily credit ratings on local, small and medium sized corporates (SMEs), and whose rating process is based on large amounts of historical data on SMEs and on statistical models developed to interpret this information.
95. ESMA found that the methodologies in place did not always provide sufficient information with regard to the qualitative assessment conducted by analysts and could not be systematically applied. Further, ESMA identified shortcomings in respect of the measures established to ensure that credit ratings are based on a thorough analysis of all available information, and in respect of a credit rating being only assigned when there is sufficient entity specific information according to the applicable methodology. Finally, internal





controls within the rating process did not systematically ensure that: (i) analysts have all information and means to verify the appropriateness of the statistical model output; and (ii) an adequate audit trail of the analytical activity is kept.

96. These investigations resulted in remedial actions that the CRAs are currently implementing to foster a thorough and systematic analytical assessment and a transparent and sound rating process, in order to ultimately improve the credit rating quality. In particular, ESMA required the CRAs to: (i) enhance the level of guidance provided to analysts to perform their analytical assessment, especially as regards qualitative factors; (ii) ensure that analysts gather all available information on the firm to be rated and that a firm is only rated when a minimum set of information is available; (iii) ensure that rating analysts are provided with all required information and tools to perform a thorough qualitative assessment, including arrangements that enable analysts to perform sensitivity analyses of the relevant key rating factors; (iv) enhance the audit trail of the analytical process; and (v) enhance the disclosure of rating methodologies and rating reports to the public and users of credit ratings.
97. ESMA expects that CRAs provide detailed explanations of the factors included in the rating methodologies and of the manner in which analysts should assess these factors, in particular with respect to the factors included in the qualitative assessment. This is elemental for maintaining the rigorousness of rating methodologies, thereby ensuring a systematic assessment of the same factors across credit ratings and time, throughout both the quantitative and the qualitative assessment.
98. Furthermore, when issuing a credit rating, regardless of the rated firm's or instrument's characteristics and complexity, CRAs must gather all available and relevant firm-specific information (in terms of quality and coverage) necessary to issue a credible credit rating. This is an essential aspect to ensure that the analysts' assessment is thorough and complete.
99. In addition, ESMA expects that information on the rationale supporting analysts' rating decisions is recorded in a comprehensive and meaningful manner throughout the rating process to allow for adequate challenge, to enable supervisors and other control functions to verify the assessment performed, and to promote consistency of credit ratings across time and firms.
100. Finally, to allow users of credit ratings to conduct their own due diligence regarding the relevance of the credit ratings for their needs, CRAs need to ensure adequate levels of transparency by enhancing the disclosure of rating methodologies and rating reports to the public and users of credit ratings. ESMA expects all CRAs, regardless of their size and scope of activity, to reflect the above principles in their rating process and methodological framework.
101. ESMA also conducted an investigation into the development, approval, and validation of a specific model and the related rating methodology of a CRA. In this investigation, ESMA



focused on the allocation of roles and responsibilities, the applicable internal control mechanisms and their implementation, and the corresponding records and documentation.

102. ESMA's investigation found that unclear policies and procedures for the development, testing, and approval of methodologies resulted in the publication of a methodology without full review and approval of the model by the review function. Finally, the investigation revealed shortcomings in the internal controls over the end-to-end process of methodologies' development, validation, and approval of new methodologies such as insufficient control due to scarcity of expert resources, and lack of a clear allocation of the responsibility and accountability for the oversight of the entire process.
103. The CRA implemented remedial actions following the investigation. In particular, the CRA strengthened its model development processes, as well as its relevant policies and procedures, clarifying responsibilities and accountability between the analytical teams and the independent review function (IRF).
104. ESMA expects that CRAs establish policies and procedures, which clearly allocate roles and responsibilities in the methodologies' approval process in a way that ensures the independence of the IRF in accordance with the CRA Regulation. ESMA also expects that CRAs establish controls so that the IRF is adequately staffed in terms of sufficient number of employees and appropriate expertise.
105. Finally, in 2018, ESMA initiated two investigations on the process to assign credit ratings to individual instruments (issue credit ratings). These investigations, which are still ongoing, focus on: (i) the quality of the rating process, including the regular monitoring and review of credit ratings; and (ii) the adequacy and efficiency of the relevant internal controls.

#### *Portfolio risk*

106. ESMA's portfolio risk assessment measures - by use of statistical means - the ability of a credit rating agency to rank-order rated issuers/entities or instruments by relative credit risk. In addition, ESMA monitors large positive or negative shifts in credit ratings at asset class and individual firm level. From a supervisory perspective, ESMA's risk assessment tends to focus on specific movements in credit ratings and large changes in credit rating distributions. Large credit rating changes in either direction (e.g. upgrades and downgrades) are not in themselves an indication that the regulatory requirements have been breached. However, these movements and shifts may be indicative of non-compliance in a number of areas, such as rating methodology validation and development, internal controls, conflicts of interest.
107. Compared to 2017, where portfolio risk was still relatively high across all CRAs, in 2018, ESMA has observed a significant overall decline in the number and severity of credit rating upgrades and downgrades. Nonetheless, ESMA has observed certain outliers (e.g.





significant upgrades or downgrades). Where ESMA has an indication that such strong credit rating moves may point to non-compliance with the CRA Regulation, ESMA may decide to take further supervisory actions vis-à-vis the CRA concerned.

### *Validation Guidelines*

108. The Validation Guidelines set out ESMA's expectations on the use of quantitative and qualitative measures in validating rating methodologies and establish minimum standards in a significant area of the CRA Regulation where ESMA has seen significant divergences in market practices.<sup>28</sup>

109. In 2017, to highlight the importance of this subject ESMA sent to all CRAs a letter, which included a questionnaire for CRAs to explain their implementation of the Validation Guidelines. The results of the questionnaire have allowed ESMA to review the implementation of the guidelines by CRAs and identify any supervisory action in line with ESMA's risk-based approach.

110. During 2018, ESMA sent tailored feedback letters to each CRA outlining some of the identified key concerns following the assessment of the CRAs' responses to the validation questionnaire. In this context, ESMA has observed a significant progress as a number of CRAs now align their validation measures to include the techniques outlined in the Validation Guidelines. ESMA is actively following-up with these CRAs and with CRAs that still need to implement certain key changes, and will continue this work throughout 2019. Furthermore, ESMA sent a letter to each CRA's Independent Non-Executive Director(s) (INEDs) regarding their engagement in the validation and review of credit rating methodologies. In these letters, ESMA provided clarifications as to which aspects INEDs should consider when providing their opinion to the Board.

### 2.2.3 Technology, security, and internal controls

111. IT, information security, and internal controls have been important topics for ESMA in 2018 due to the high levels of risk identified in these areas in the 2017 risk assessment. Given the importance of these topics, ESMA encourages firms to be more forthcoming in sharing information with ESMA in a practical manner. In this context, it is also important that compliance functions act proactively and engage in technology-related issues.

112. To assess the effectiveness of the IT, information security, and internal controls, ESMA: (i) enhanced its IT, information security, and internal control risk assessment framework, rendering it consistent across the two supervised industries, and established an IT and information security incidents reporting procedure; and (ii) assessed the relevant information firms submitted (e.g. compliance work plans and reports, compliance assessment reports, internal audit reports (where available), Enterprise Risk

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<sup>28</sup> [https://www.esma.europa.eu/sites/default/files/library/2016-1575\\_guidelines\\_on\\_cras\\_methodologies\\_1.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-1575_guidelines_on_cras_methodologies_1.pdf)



Management (ERM) or risk management procedures and risk dashboards, organisational changes regarding internal control functions, IT governance and strategy, IT and information security incidents, and project plans of significant business and IT projects).

113. ESMA has also worked to streamline and clarify the information it needs to receive from CRAs in their periodic information submissions. Furthermore, ESMA published the new Periodic Information Guidelines for CRAs on 5 February 2019 (see also Section 3.1).

#### *Information Technology process and systems*

114. Through interaction with key staff, ESMA has monitored developments in this on-going area of focus and communicated its supervisory concerns to the firms.

115. The main developments relate to the increasingly technology-driven basis of the CRAs' operations, IT governance changes and weaknesses, the key large-scale IT projects foreseen, and the significant use of IT outsourcing, including the move of the CRA business – almost exclusively – to cloud computing implementations.

116. As already reported in 2017, a number of CRAs are still undergoing important changes to their IT architecture and environment. On the one hand, in 2018, ESMA has observed delays in the implementation of recommended projects, difficulties with third party providers and IT outsourcing, and incidents related to network misconfigurations. On the other hand, the senior management of CRAs seems to become more aware of and more involved in IT risk discussions.

117. As the implementation of such IT projects spans over many years, the respective IT risks have become more present in 2018 for the following reasons: (i) the delay of such projects is now not only posing a risk to the improvement of the rating business operations, but it creates additional concerns linked to the ageing infrastructure and legacy applications that may no longer be able to support the new needs of the business; and (ii) the need of firms to adopt different technological models to take advantage of financial innovation solutions to improve the rating business. By the time the implementation of these large-scale IT projects, designed years ago, is closer to finalisation, the firm may already be half-way through implementing new IT projects that would replace or discontinue the former ones.

118. Following ESMA's intensive engagement with a CRA, the firm is undertaking a number of changes to its IT governance structure to increase the efficiency of deliveries and support effective decision-making.

119. As regards the increased use of cloud computing, ESMA has systematically stressed that, while cloud computing may offer many benefits, firms need to be mindful of its specificities and risks and apply adequate controls when moving to the cloud. In the context of its cloud computing project, ESMA performed a stock-taking of cloud computing implementations and identified certain concerns. ESMA is closely monitoring associated



risks, such as data stored in non-EU locations, decision-making and governance processes, and especially the overreliance on cloud service providers (see Section 3.3 for a more detailed overview).

120. ESMA also provided its views on the use of cloud computing in a letter, highlighting the major risk areas and the importance of the topic for compliance with CRA Regulation requirements (see Section 3.3).

#### *Information security and cybersecurity*

121. Given the high risks related to cybersecurity, ESMA is monitoring the cybersecurity threat landscape and any information on security incidents CRAs report to ESMA on an on-going basis. In 2018, ESMA noted the following risk drivers: (i) independence of the information security function; (ii) information security risk management practices; (iii) low to moderate maturity of cybersecurity controls; (iv) and information security controls in outsourcing. As regards the organisation and governance of information security functions, ESMA has continuously stressed the importance of information security as a control area and expects information security to be independent from IT departments and functions. However, not all CRAs have established information security functions in a way that allows them to discharge their responsibility in a fully independent and objective manner. In this context, ESMA also noted that the information security policies of some CRAs are not consistently aligned with industry leading practices. However, the CRAs' awareness regarding the importance of the information security organisations is increasing, e.g. more CRAs intend or are in the process of appointing Chief Information Security Officers to ensure that information security is an independent function within the overall organisation.

122. As regards the adequacy and effectiveness of cybersecurity controls, ESMA observed issues related to access controls, lack of encryption, and inadequate user account management practices, as well as an excessive focus on technical and IT-based controls. Furthermore, ESMA has concerns regarding the overreliance of CRAs on the security control environments of cloud computing service providers.

123. Finally, ESMA has identified certain weaknesses regarding information security risk management practices, which are not always based on systematic methodologies and not consistently integrated within the overall risk management framework.

#### *Internal control*

124. Although this is an on-going area of focus, ESMA has remarked slight improvements regarding some aspects of CRAs' internal controls. For example, certain CRAs have strengthened their compliance culture, while decreases in incidents and violations of policies can be observed for others. In addition, ESMA has noticed that most CRAs have become more forthcoming and more explicit in discussing their internal control frameworks with their Board and ESMA.

125. At the same time, during 2018, ESMA identified and engaged on important issues pertaining to the internal control system, as not all CRAs have effective internal control arrangements in place, especially with respect to internal audit, risk management, and monitoring activities. While there have been improvements at the tone at the top, ESMA considers that CRAs' Board and senior management can further improve their oversight with an internal control mind set.
126. ESMA identified and followed-up on many issues related to duties not being properly segregated, thus, undermining the independence of different functions (e.g. the organisational arrangements of the internal audit function are not always sufficiently defined). ESMA has also noticed that internal audit is often overused as a consultancy function or a substitute for compliance monitoring tasks. Furthermore, ESMA observed that the enterprise risk management process is not effective across many CRAs and that its maturity may be lagging behind that of the financial sector in general.
127. A key component of CRAs' internal control framework relates to ensuring that CRAs avoid conflicts of interest or manage such conflicts adequately when they are unavoidable. This is essential to ensure that CRAs do not engage in credit rating activities that may create potential conflicts of interest and compromise the independence of their credit ratings. In this context, a fundamental area, which ESMA expects all CRAs to focus on, is to monitor the activities of shareholders, such as investments or Board memberships. Further to monitoring these activities, CRAs should have adequate and effective internal controls in place to ensure that these conflicts are eliminated, or managed and disclosed, through adequate disclosure arrangements.
128. In this context, ESMA conducted an investigation in 2018 to assess a CRA's compliance with the regulatory requirements for the independence and avoidance of conflicts of interests in relation to the CRA's shareholders. The focus was on the measures taken by the CRA to identify and manage such conflicts of interest.
129. ESMA's investigation found that the CRA's procedures were not wholly aligned with the regulatory requirements. Consequently, the CRA faced a situation where a (potential) conflict of interest existed and should not have issued new credit ratings related to the entity or issue affected by this conflict. In addition, ESMA found that the CRA's internal control mechanisms in its first and second lines of defence were not sufficiently robust as regards the CRA's process for identifying and managing conflicts of interest linked to the CRA's shareholders. Finally, the CRA had both under-disclosed and over-disclosed situations of (potential) conflicts of interest.
130. Following the investigation, the CRA is implementing remedial actions to align its procedures with the regulatory requirements, strengthen its processes to identify shareholders and their activities, and enhance its internal control structures and disclosure arrangements.



131. ESMA's investigation found that the CRA's procedures were not wholly aligned with the regulatory requirements. Consequently, the CRA faced a situation where a (potential) conflict of interest existed and should not have issued new credit ratings related to the entity or issue affected by this conflict. ESMA expects CRAs to design internal control mechanisms across all lines of defence, to prevent overreliance on limited sources of information or on key personnel to identify potential conflicts of interest with their shareholders. Finally, CRAs should design disclosure arrangements of any potential conflicts of interest, including accessibility, comprehensibility, clarity, and meaningfulness for an average investor.
132. Based on the overall investigations conducted in 2018, ESMA would like to remind market participants that CRAs should, at the very least, ensure that an appropriate dialogue between all key internal control stakeholders takes place whenever an item represents a shared responsibility. Furthermore, ESMA expects CRA's senior management and internal control function resources to further consider and support actions embedding sound, compliance-oriented behaviour for all staff.

#### 2.2.4 Strategy and governance

133. In response to the UK's decision to withdraw from the EU-27, several CRAs have decided to establish new legal entities in the EU-27, which also drives some of their important strategic and governance decisions.
134. ESMA continuously monitors the strategy and governance of CRAs by assessing the periodic information CRAs submit. ESMA also has regular interactions with senior management and INEDs to understand and assess the strategic direction and governance of CRAs.

##### *Material changes*

135. CRAs are required to notify ESMA of any material changes to the initial conditions of their registration. These notifications may pertain to a wide variety of topics, including the opening and closing of branches, changes in business structure, personnel changes in the compliance and internal review function, or the appointment of new Board members.
136. ESMA thoroughly assesses these notifications to ensure that the CRA still meets the conditions under which it was registered. If ESMA is concerned that the initial conditions for registration may no longer be met, ESMA may inform the CRA that it needs to refrain from undertaking the change or re-apply for registration. It is therefore very important that CRAs pro-actively discuss with ESMA and provide all relevant information regarding complicated organisational changes or transactions.
137. In 2018, ESMA has assessed a wide variety of notifications, including the transfer of credit rating business from a CRA into a new legal entity, the acquisition of an EU CRA by non-EU CRAs, changes in outsourcing agreements, and various notifications related to Brexit



(e.g. changes in the ownership or legal structure of CRAs). On average, ESMA receives approximately 75 notifications of material changes by CRAs within a calendar year.

### 2.2.5 CRAs – Enforcement

138. In 2018, ESMA took one enforcement decision. ESMA found that five banks infringed the CRA Regulation by issuing credit ratings without being authorised by ESMA to do so.

139. In particular, under the CRA Regulation, issuing credit ratings requires authorisation by ESMA to ensure that such credit ratings are independent, objective, and of adequate quality and that CRAs are subject to the same rules and oversight across all EU countries. To be registered as a CRA in the EU, a firm needs to demonstrate that it fulfils the necessary organisational requirements and that it provides adequate safeguards, in particular with regard to governance, conflicts of interest, internal controls, rating process and rating methodologies, business activities, and disclosures.

140. Between June 2011 and August 2016, Danske Bank, Nordea Bank, Svenska Handelsbanken, and Swedbank, and SEB until May 2018, issued credit research on different firms and underlying financial instruments. The credit research included the issuance of what the banks referred to as *shadow ratings*. ESMA's Board of Supervisors found that these *shadow ratings* met the definition of a credit rating under the CRA Regulation.<sup>29</sup> However, none of the five banks had acquired the necessary ESMA authorisation to issue credit ratings prior to the issuance of the shadow ratings. ESMA's Board of Supervisors also found that the five banks had committed this infringement negligently. Consequently, ESMA's Board of Supervisors imposed on each bank a fine of EUR 495,000.

## 3 Common areas of supervision in 2018

141. As identified in its supervision work programme 2018, ESMA has worked on a number of common areas of focus for CRAs and TRs. To exploit synergies that exist between the supervision of these two types of supervised entities, ESMA has performed joint work on:

- Periodic information Guidelines;
- Internal control system;
- Cloud computing;

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<sup>29</sup> The respective Decisions of the ESMA Board of Supervisors are available at:

[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1153\\_final\\_bos\\_decision\\_-\\_cra\\_2-2017\\_-\\_seb.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1153_final_bos_decision_-_cra_2-2017_-_seb.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1152\\_final\\_bos\\_decision-cra\\_2-2017-swedbank.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1152_final_bos_decision-cra_2-2017-swedbank.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1150\\_final\\_bos\\_decision-cra\\_2-2017-nordea.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1150_final_bos_decision-cra_2-2017-nordea.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1147\\_final\\_bos\\_decision-cra\\_2-2017-handelsbanken.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1147_final_bos_decision-cra_2-2017-handelsbanken.pdf);  
[https://www.esma.europa.eu/sites/default/files/library/esma41-137-1145\\_final\\_bos\\_decision-cra\\_2-2017-danske.pdf](https://www.esma.europa.eu/sites/default/files/library/esma41-137-1145_final_bos_decision-cra_2-2017-danske.pdf)





- Brexit;
- Fees and ancillary services; and
- Risk assessment and supervisory tools.

### 3.1 Periodic Information Guidelines

142. The information received from supervised firms is essential to ensure that ESMA is capable to efficiently and effectively supervise the CRA and TR industry. To provide for harmonised timeframes, standardised templates, and consistency of the information provided, ESMA published the new Periodic Information Guidelines for CRAs on 5 February 2019<sup>30</sup> and begun the development of new Guidelines for TRs.

143. Certain periodic reporting requirements will be common across both industries, e.g. the requirement to regularly provide copies of Board meeting minutes, compliance reports, or internal audit reports. Other periodic reporting requirements, such as data-related information, will be industry-specific. The Guidelines for both sectors will streamline the periodic aspect of the information collection process and will increase predictability for CRAs and TRs in their interactions with ESMA.

144. ESMA conducted a roundtable regarding the revised Periodic Information Guidelines for CRAs during the second half of 2018.<sup>31</sup> Besides adapting the reporting burden to the specific risk profile of each supervised firm, ESMA focused on the simplification and standardisation of several periodic reporting requirements by adopting a number of templates. These are to be published and maintained on the ESMA website. The use of these templates will guarantee increased predictability and comparability of the information and enable more performant processing and information analysis by ESMA.

145. ESMA is currently developing the Guidelines for TRs and will most likely publish them for consultation with the industry in 2019. In contrast to CRAs, such Guidelines did not exist for TRs. However, in the past years, there were some periodic reporting requirements, based on ESMA's requirements, to which TRs adhered. As soon as the periodic information requirements for TRs are formalised, ESMA expects that the completeness, timeliness, and comparability of the supervisory information will improve and feed into ESMA's risk-based supervision.

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<sup>30</sup> [https://www.esma.europa.eu/sites/default/files/library/esma\\_33-9-295\\_final\\_report\\_guidelines\\_on\\_the\\_submission\\_of\\_periodic\\_information\\_to\\_esma\\_by\\_credit\\_rating\\_agencies.pdf](https://www.esma.europa.eu/sites/default/files/library/esma_33-9-295_final_report_guidelines_on_the_submission_of_periodic_information_to_esma_by_credit_rating_agencies.pdf)

<sup>31</sup> <https://www.esma.europa.eu/press-news/consultations/consultation-revised-guidelines-periodic-reporting-cras>



## 3.2 Internal control system

146. In accordance with its supervision work programme 2018, ESMA worked to finalise its supervisory views as to what constitutes an effective internal control system for firms. ESMA's views are based on ESMA's existing and ongoing engagement with supervised firms on this subject and (i) the regulatory provisions relevant to internal controls; (ii) existing CRA and TR industry practices; (iii) EU approaches and guidance on internal control; and (iv) internationally recognised internal control standards, e.g. the COSO framework.<sup>32,33</sup>

147. For 2019, ESMA also intends to provide public guidance in this area.

## 3.3 Cloud computing

148. In accordance with its supervision work programme 2017 and 2018, ESMA has launched a supervisory project on cloud computing. The main objective of this project was to explore the compliance risk of the use of cloud computing services for CRAs and TRs, with a view to formulating a clearer supervisory response and strategy. To achieve this, ESMA performed a stock-taking of the actual cloud computing implementations of some supervised firms (both CRAs and TRs) and identified generic key risk areas related to the use of cloud computing based on: (i) CRA Regulation and EMIR requirements; (ii) ESMA's supervisory experience in IT and information security risk for both CRAs and TRs; (iii) EBA's recommendation regarding outsourcing to cloud service providers (CSPs); and (iv) other relevant internal standards and industry leading practices. ESMA communicated these key risk areas to the senior management and Board of CRAs and TRs and expects the firms to focus their control activities on these risk areas. ESMA also identified key concerns regarding the firms' control arrangements of the cloud computing implementation. ESMA further engaged with these firms to address the concerns.

149. In the context of this activity, ESMA noted that, especially for the CRA industry, any absence of regulatory direction has not hindered the firms to outsource their services to the cloud. Prior to their move to the cloud, some of these firms had not engaged much with ESMA. In addition, some firms reported that key factors, possibly hindering entities to enter the cloud, mostly relate to the risks of the cloud computing paradigm itself and the cost linked to the actions a firm would need to take to address these risks. Some firms also reported difficulties in negotiating bespoke terms with CSPs.

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<sup>32</sup> European Commission's 'Internal Control Framework': Communication to the Commission from Commissioner Oettinger, Revision of the Internal Control Framework, Brussels, 19.4.2017C(2017) 2373 final; European Banking Authority, Final Guidelines on Internal Governance, EBA-GL-2017-11.

<sup>33</sup> COSO Internal Control – Integrated Framework, May 2013 © 2013, Committee of Sponsoring Organisations of the Treadway Commission (COSO), U.S.A.





150. In both industries, there are firms that have opted to fully outsource their EU-regulated processes and data into CSPs. There are also a few firms that have opted for a phased approach, moving supporting services into the cloud, while they are still considering further outsourcing for the rest of their EU-regulated business activities.
151. In summary, ESMA has identified the following main generic risk areas: (i) Board and business involvement in the decision-making regarding the use of cloud computing; (ii) risk assessment and due diligence prior to moving to the cloud; (iii) over-reliance on CSPs' control environment; (iv) contractual arrangements with CSPs; (v) information security and business continuity, including lock-in risk, interoperability, and reversibility capability, as well as data location; and (vi) impairing ESMA's ability to discharge its supervisory tasks, including notification of the use of cloud computing, and rights of access and audit by ESMA.
152. With regard to the firms it has engaged with, ESMA has already identified concerns in all the above-mentioned areas and is currently working with these firms to address the concerns.
153. In addition, ESMA will be requiring firms to notify the use of cloud computing services for their EU-regulated processes and data. To this effect, ESMA has already included this in its new Periodic Information Guidelines on CRAs together with a notification template.<sup>34</sup>
154. Based on this work, ESMA will also communicate its response to the European Commission FinTech Action Plan (Paragraph 2.2., Box 5, Point 1).<sup>35</sup>

### **3.4 Brexit**

155. Currently, ESMA supervises the following CRAs and TRs established in the UK: AM Best Europe-Rating Services Ltd., DBRS Ratings Limited, Fitch Ratings Limited, Fitch Ratings CIS Limited, Moody's Investors Service Ltd, Moody's Investors Service EMEA Ltd, The Economist Intelligence Unit Ltd, DTCC Derivatives Repository Plc, UnaVista Limited, CME Trade Repository Ltd., ICE Trade Vault Europe Ltd., and Bloomberg Trade Repository Limited.
156. As regards the big 3 CRAs, Moody's and Fitch have legal entities established both in the EU-27 and in the UK. S&P does not currently have any registered legal entity in the UK due to the fact that in 2018 all S&P entities operating in the EU merged into S&P Global Ratings Europe Limited (SPGRE), a Dublin-based company. S&P continues to operate from its previous locations in Europe, including UK, which have now become branches of SPGRE.

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<sup>34</sup> [https://www.esma.europa.eu/sites/default/files/library/esma33-9-252\\_revised\\_guidelines\\_on\\_periodic\\_reporting.pdf](https://www.esma.europa.eu/sites/default/files/library/esma33-9-252_revised_guidelines_on_periodic_reporting.pdf)

<sup>35</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0109>



157. During 2018, as there was no assurance that a transition period will be agreed, ESMA made it clear to market participants that they needed to consider the scenario where a no-deal Brexit would take place on 29 March 2019. This is of particular importance for TRs considering that derivatives subject to the reporting obligation under EMIR must be reported to an EU-based TR registered or a third country TR recognised by ESMA. Similarly, CRAs need to have a legal entity registered in the EU and supervised by ESMA, in order for their ratings to be used for regulatory purposes in the EU. In a no-deal Brexit scenario, UK-based TRs and CRAs will lose their EU registration as of the UK's withdrawal date.
158. The majority of the UK CRAs and TRs expressed their intention to continue providing their services in the EU-27 after Brexit and implemented in 2018 subsequent actions, such as: (i) applied to register a new legal entity in the EU-27; (ii) notified ESMA of material changes concerning the organisation of the entities already registered in the EU-27 (e.g. strengthening the presence of staff in the EU27). ESMA has made it clear in its bilateral communications to CRAs and TRs that any registered TR and CRA in the EU-27 should comply with minimum substance requirements and relevant outsourcing conditions to ensure that the post-Brexit set-up in the EU-27 is as strong as the pre-Brexit set-up in the EU.
159. In December 2018, ESMA registered two CRAs, namely DBRS Ratings GmbH – based in Frankfurt - and A.M. Best (EU) Rating Services B.V. – based in Amsterdam. Both CRAs were established in direct response to the UK's decision to withdraw from the EU and in order to ensure continuity of rating services from DBRS and AM Best in the EU-27. ESMA is currently assessing two TRs applications, submitted as part of the firms' Brexit contingency plans.
160. ESMA is engaging on a continuous basis with the relevant supervised entities to ensure that the agreed Brexit contingency plans are fully executed by March 2019 in case of no-deal Brexit, including the finalisation of pending applications for registration.

### **3.5 Fees and ancillary services**

161. In January 2018, ESMA published a thematic report on fees charged by CRAs and TRs.<sup>36</sup> In the report, ESMA identified the key areas of concern across the CRA and TR industries with regard to the fee provisions and indicated where improvements are needed in the existing practices. In particular, ESMA noted that transparency, disclosure, fee setting, and cost monitoring processes could be improved in both industries. ESMA also noted additional challenges and risks posed by credit rating-related services provided by affiliates of CRAs.

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<sup>36</sup>[https://www.esma.europa.eu/sites/default/files/library/esma80-196-954\\_thematic\\_report\\_on\\_fees\\_charged\\_by\\_cras\\_and\\_trs.pdf](https://www.esma.europa.eu/sites/default/files/library/esma80-196-954_thematic_report_on_fees_charged_by_cras_and_trs.pdf)



162. Upon the publication of the report, ESMA continued to monitor the initiatives CRAs' and TRs' took in relation to ESMA's findings and expectations as set out in the report with respect to the 'cost-based/cost-relatedness' and 'non-discriminatory' principles and the need for more 'transparency' towards customers. ESMA further engaged with the supervised firms and the users of their services. In this context, ESMA observed that some firms: (i) have taken, or are taking, actions in response to the findings and expectations outlined in the report; (ii) are performing internal assessments to determine to which extent their existing practices meet the regulatory requirements and are in line with ESMA's expectations; (iii) updated their pricing policies and enhanced publicly available information; and (iv) are re-organising their revenue and cost management systems at more global level.
163. To ensure that all the observations set out in the report are duly addressed, ESMA will further maintain its supervisory focus on the identified key areas of concerns. In addition, ESMA has started to work on the new reporting requirements for CRAs and TRs that, among other things, will help to increase the visibility of fees, revenues, costs, and client information on a periodic basis.
164. Finally, specifically on the CRA side, ESMA notes that the feedback from the industry and the users of credit ratings calls for additional clarification on the scope of the CRA Regulation regarding the distribution by affiliated firms of credit rating data and content produced by the CRAs as well as the use of credit rating information by investors/clients, including for regulatory purposes. ESMA will continue its work aiming at providing the necessary clarifications in this regard.

### **3.6 Risk assessment and supervisory tools**

165. ESMA has been exploring artificial intelligence and machine learning technologies to identify, assess, and implement use cases, tools, and techniques that could support the effectiveness and efficiency of several supervisory processes.
166. More specifically, ESMA has been experimenting and testing with neural networks and other supervised and non-supervised learning algorithms in the areas of dimensionality reduction and visualisation of multi-dimensional data, classification, clustering, anomaly detection, as well as with natural language processing routines for text summarisation, key terms similarity searching and matching, topic modelling, and sentiment analysis.
167. ESMA has developed and is testing artificial intelligence and machine learning scripts for anomaly detection in the data that TRs make public and the respective Trade State reports that TRs regularly provide to ESMA. In addition, similar scripts are tested as regards the automated summarisation of documents as well as the similarity searching and matching of key terms/phrases in support of ESMA's review of periodic information and risk assessment.



168. In 2018, ESMA selected a risk management tool to establish an integrated platform which will further support the supervisory processes and their effectiveness. The tool will be implemented and customised to follow the current supervision risk-based approach. This will enrich the current approach with additional functionality for collecting and linking different data and information, incident reporting and issue management, a more streamlined workflow capability, and a wide variety of reporting features and visualisations. Furthermore, it will facilitate the allocation and prioritisation of tasks among supervisors as well as introducing more clarity and structure when linking risks with the relevant supervisory strategies and actions.

## **4 Supervision work programme for 2019**

### **4.1 Introduction**

169. ESMA uses a risk-based approach to establish its annual work programme for CRAs and TRs. The risk assessment takes into account all the information available to ESMA, e.g. information collected from previous supervisory activities, (periodic) information supervised firms report, information NCAs, market participants, and third country regulators communicate to ESMA, and information ESMA obtains through its own market intelligence.

170. ESMA's risk assessment takes into account risks both at a firm and at an industry level. It builds on the observed market trends and current state of the CRA and TR industry in the EU. As described in Sections 1.1 and 2.1, some of the industry-level factors that ESMA has taken into account in this year's risk assessment are the competitive dynamics, regulatory changes, and technological developments. Important to note is that ESMA continuously receives information regarding CRAs and TRs. This information is used to update the risk assessment of the supervised firms and may result in re-prioritisation over the course of the year.

171. In defining its supervisory actions to address the identified risks, ESMA does not use a one-size-fits-all approach, but tailors its actions to the type of risk or challenge at stake, taking into account the urgency of the case, size, complexity and history of the supervised firm. In addition, ESMA differentiates its approach depending on the objective it wants to achieve. In some instances, ESMA adopts a thematic approach, which creates an opportunity to look at certain issues across firms and allows for peer comparisons. In other cases, where risks seem to impact a specific firm, ESMA takes more focused action like targeted letters, investigations, on-site inspections or engagement with the compliance function, senior management, or Board of the supervised firm.



172. For 2019, there is a strong need to prioritise supervisory activities due to a relatively large number of external factors that affect ESMA's supervision. The external factors that will be a key priority for ESMA's Supervision Department in 2019 are Brexit and the entry into force of SFTR, which is expected to trigger various applications for registration. In 2019, ESMA expects the entry into force of the Securitisation Regulation, which will also necessitate preparatory work during the year.

173. Based on its risk assessment and the external factors described above, in 2019 ESMA will have a number of supervisory priorities that are common across CRAs and TRs, including the follow-up on the fees thematic report, the effectiveness of the supervised firms' internal control systems, and the use of new technologies. Although ESMA will have a common approach to these issues, it will tailor its actions to the specificities of the different industries.

174. In addition to the common areas of supervision, ESMA has identified areas of focus that apply specifically to CRA and TR supervision, which are described further in Sections 4.3 and 4.4 below. In addition, ESMA will also carry out general supervisory activities, including day-to-day monitoring and assessment of registration applications.

175. The following sections provide an overview of the work, which ESMA intends to perform in 2019. The overview starts with the common areas of supervision for both CRAs and TRs.

## **4.2 Common areas of supervision in 2019 across TRs and CRAs**

### **4.2.1 Brexit**

176. The coming year will be essential for the execution of the Brexit contingency plans for both CRAs and TRs. Supervised firms need to ensure that all necessary steps are taken in a timely manner to prevent any market disruption when the UK leaves the EU.

177. In 2019, ESMA will focus its supervisory efforts to ensure that the supervised firms' Brexit contingency plans are fully implemented by Brexit date and that the following key milestones are achieved: (i) CRAs and TRs execute the planned actions to ensure that the post-Brexit set-up in the EU-27 is as strong as the pre-Brexit set-up in the EU-28 (e.g. transfers of personnel or new hires to strengthen the presence of staff in the EU-27); (ii) EU-27 ratings are transferred to a EU-27 registered CRA and CRAs have an objective reason for the ratings remaining outside the EU-27, as put forth in ESMA's Endorsement Guidelines; (iii) EU-27 counterparties previously reporting to UK TRs have transferred their data to a EU-27 TR in accordance with ESMA's Guidelines on Portability and further communication provided by ESMA to TRs; (iv) applications for registration of new legal entities established in response to Brexit are finalised.



178. ESMA expects to dedicate resources to Brexit also after Brexit date. ESMA will closely monitor that any residual step to be undertaken as part of the supervised firms' Brexit contingency plans is properly finalised. ESMA will also continue to engage with CRAs and TRs after the Brexit date to ensure that the operations of the regulated entities in the EU-27 are fully functional and to ensure a smooth transition from pre-Brexit to post-Brexit. ESMA will also set up the relevant supervisory cooperation (supported by the relevant MoU) with the Financial Conduct Authority as the future authority responsible for authorisation, supervision, and enforcement in relation to CRAs and TRs.

#### 4.2.2 Fees

179. In its thematic report on fees charged by TRs and CRAs published in January 2018, ESMA identified a set of key areas of concern across the CRA and TR industries with regard to the fee provisions of the CRA Regulation and EMIR. ESMA indicated that improvements were necessary in the existing practices as well as clarified its expectations. After the publication of its thematic report, ESMA has followed up and will continue to engage with supervised firms and their clients to monitor developments in the practices established by TRs and CRAs in light of the concerns identified. As part of its follow-up work, ESMA will consider the need to publish a state of play report.

180. As set out in Section 3.5, ESMA will continue its work to further clarify the scope of the CRA Regulation regarding the rating-related activities performed by firms affiliated to CRAs. This includes the distribution of credit rating data produced by CRAs as well as the licensing services for the use of credit rating information by investors/users of ratings, including for regulatory purposes.

#### 4.2.3 Effective internal control system

181. As set out in Section 3.2, ESMA has compiled views individually communicated to supervised firms as to what constitutes an effective internal control system. In 2019, ESMA will continue to communicate individual concerns to supervised firms and monitor, where necessary, remedial actions.

182. In 2019, ESMA intends to further build on this work with the objective to introduce public guidance for internal control at a later stage.

#### 4.2.4 Use of new technologies

183. Another high priority area is the introduction and use of new technologies across the TR and CRA industries. As many of ESMA's supervised firms already use or are considering using new technologies, ESMA will assess the impact of using new technologies across both industries and the associated risks through engaging with the industry and other stakeholders.



184. As regards the CRA industry, ESMA will focus on the integration of data-related technologies in the rating process to explore the potential impact on the quality of the credit rating process. For instance, where CRAs target an increased automation of the rating process, ESMA expects specific controls to be developed in parallel to mitigate potential risks, e.g. overreliance on automation and machine-learning bias, and lack of sufficient analytical oversight.

185. As regards the TR industry, ESMA will be monitoring the adoption, integration, and control of artificial intelligence, machine learning, and distributed ledger technologies in the TRs' core service offerings like data ingestion and validation, data processing and report generation and dissemination to authorities and market participants.

#### 4.2.5 Supervisory tools

186. In the coming years, ESMA intends to further build on its work regarding the use of artificial intelligence and machine learning technologies to support supervisory processes. In 2019, ESMA will continue to evaluate the effectiveness and efficiency of these technologies as supervisory instruments in light of their integration into the regular supervisory processes.

187. Furthermore, ESMA intends to expand the scope of potential applications for the use of these technologies in 2019. Once ESMA has verified the accuracy, sensitivity, and stability of the respective tools using the existing test cases, the scope of potential applications may be expanded. In addition to applying these tools to TR data as described in Section 3.6, ESMA also intends to assess potential applications to CRA data, e.g. performing outlier detection in credit rating data.

188. As set out in Section 3.6, ESMA has selected a risk management tool to support the supervisory processes and their effectiveness. Following the implementation in early 2019, ESMA will first customise the risk management tool according to its needs, then proceed to a testing phase, and finally launch it into production once it has been approved.

### 4.3 Work programme for Trade Repositories

189. As regards trade repositories, ESMA has identified the following areas of focus:

- i. Data quality and access by authorities;
- ii. IT process and system reliability;
- iii. Business continuity planning; and
- iv. SFTR and SR.





#### 4.3.1 Data quality

190. Data quality remains a key area of concern for ESMA. In 2019, ESMA will continue its ongoing supervisory activities that are part of the DQAP, including its engagement with authorities via the data quality log and its monitoring activities through data re-validation, inter-TR reconciliation, and the data quality dashboard.

191. In addition, ESMA will focus on the following areas and supervisory activities in the context of the DQAP: (i) assessment of the quality of the produced reports on position calculation; (ii) assessment of the completeness of EMIR data provided to NCAs by TRs in terms of access filtering; (iii) assessment of the accuracy of calculations of public data provided by TRs; and (iv) monitoring and assessment of data quality in the context of Brexit related activities such as Portability, EMIR data storage, recordkeeping, and access by authorities.

#### 4.3.2 IT process and system reliability

192. As TRs will implement position calculation in 2019, ESMA will closely monitor the implementation progress to ensure TRs' ability to produce position calculation reports in accordance with regulatory requirements.

193. Based on its work to accelerate compliance with the Guidelines on Portability in 2018, ESMA will continue to monitor the implementation of the Guidelines on Portability across the TR industry. In this context, ESMA will closely monitor the different implementation phases and continuously engage with the various stakeholders.

#### 4.3.3 Business continuity plan

194. Based on its risk assessment of the overall TR industry, ESMA has identified the areas of business continuity and disaster recovery as a priority for some TRs for which ESMA identified issues related to the implementation, update, and testing of their business continuity and disaster recovery planning. In this context, ESMA will review the activities and effectiveness of the respective teams at entity level.

#### 4.3.4 Information Security function

195. Through its risk assessment and ongoing interaction with TRs, ESMA has observed that although all TRs have global information security functions in place, there is not much focus and activity on the specific TR matters and needs. In this respect, ESMA is planning to engage with key staff from this function to assess their scope of work, operations and adequate coverage of the TR specific needs. Depending on the outcome of this review, appropriate remedial actions might be put in place.





#### 4.3.5 SFTR and SR

196. ESMA expects that several of the TRs currently registered under EMIR will apply for an extension of registration for SFTR and SR. These applications will be a key supervisory priority during 2019.

### 4.4 Work programme for Credit Rating Agencies

197. ESMA's supervisory activities regarding CRAs will focus on the following priority areas:

- i. Portfolio risk;
- ii. Quality of the rating process; and
- iii. Cybersecurity.

#### 4.4.1 Portfolio risk

198. ESMA assesses and monitors portfolio risk, i.e. statistics that measure rating quality, on a continuous basis. As described in Section 2.2.2, through its risk assessment, ESMA has observed certain outliers in terms of credit rating actions and will follow-up on these concerns with the relevant CRAs where necessary.

199. In light of the risks identified in ESMA's Risk Dashboards in 2018<sup>37</sup>, e.g. in terms of market and credit risks, ESMA will further enhance its monitoring activities for certain asset classes. As part of its activities in this area, ESMA will closely monitor rating trends, especially in high-yield and collateralised loan asset classes to ensure CRAs comply with the requirements of the CRA Regulation. ESMA will specifically focus on the need for CRAs to (i) ensure that methodologies incorporate all key rating assumptions, (ii) employ adequate analytical resources and (iii) incorporate all available information into the rating analysis. ESMA will closely monitor market developments and follow-up on any issues identified during the risk assessment.

#### 4.4.2 Quality of the rating process

200. As detailed in Section 2.2.2, ESMA has engaged with a number of CRAs to address its concerns regarding the rating monitoring process. In view of these concerns and in light

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<sup>37</sup> [https://www.esma.europa.eu/sites/default/files/library/esma50-165-688\\_risk\\_dashboard\\_no.4\\_2018.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-165-688_risk_dashboard_no.4_2018.pdf).



of the current market context, ESMA will continue to assess the quality and controls regarding the rating monitoring process and follow-up, where necessary.

201. As a result of its engagement with market participants, ESMA has concerns with regard to the consistent application of credit rating methodologies for a number of CRAs. ESMA will assess these issues in detail and identify the appropriate supervisory action to follow-up. In addition, changes to existing methodologies will be closely monitored and assessed in light of the requirements as defined under Article 8 of the CRA Regulation and the related Regulatory Technical Standards. This includes requirements related to rigorousness, systematic application, and continuity of the credit rating methodologies.
202. In addition, as set out in Section 2.2.2, ESMA will conclude its investigations for a number of CRAs into the processes to assign credit ratings on individual debt instruments. Finally, ESMA will also continue to monitor the CRAs' implementation of the Validation Guidelines to ensure that the quantitative and qualitative measures, including the related thresholds, that have been put in place, are effectively used in the development, approval, and review of methodologies. ESMA will continue to engage with CRAs to develop and communicate best practices on the types of quantitative and qualitative measures, and related thresholds, used during the validation process.

#### 4.4.3 Cybersecurity

203. Building on similar exercises with TRs and CCPs, in 2019 ESMA will survey a subset of EU-registered CRAs with the aim to assess the current state of the cybersecurity risk environment, as perceived by the CRAs, as well as the current defence mechanisms and capabilities CRAs have employed to protect their assets from cyber-attacks.
204. More specifically, the cybersecurity review will be set up around the following key goals and objectives: (i) better understand the cyber risk and threat environment within which the CRAs operate; (ii) explore how the CRAs' perception of cyber risks compares to ESMA's view; (iii) identify major concerns about the CRAs' control environment, (e.g. cases where it is evident that due care was not taken or controls deviate significantly from industry practices); and (iv) identify areas where subsequent follow-up activities should be performed either because existing practices are inadequate and unclear or because the information collected is not sufficient to allow for supervisory assessment.

## **B. Monitoring and recognition of Third-Country Central Counterparties**



## 5 Monitoring and recognition of Third-Country Central Counterparties in 2018

### 5.1 Recognition

205. According to Article 25 of EMIR, central counterparties established in third countries (TC-CCPs) can only provide clearing services to European clearing members if they are recognised by ESMA. In addition, under the Capital Requirements Regulation (CRR), EU credit institutions, investment firms and their third country subsidiaries may only benefit from advantageous capital treatment with respect to cleared derivatives transactions, when the CCP they are facing is recognised by ESMA. This has led 50 TC-CCPs to apply for recognition to ESMA<sup>38</sup> (as of 31 December 2018).
206. One of the conditions to be fulfilled for a TC-CCP to be recognised is the adoption by the European Commission of an implementing act determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that third country comply with legally binding requirements which are equivalent to the EMIR requirements, the so-called “equivalence decision”. Another condition that needs to be respected is for ESMA to conclude cooperation arrangements with the relevant third-country authorities.
207. During 2018, no new equivalence decision has been adopted by the European Commission nor any new TC CCP recognised by ESMA. However, four new applications of TC-CCPs to be recognised in order to offer services and activities in the Union were received by ESMA.
208. Moreover, with respect to Brexit, following the European Commission’s communication on 13 November on measures to ensure continued access for EU Clearing Members and Clients to UK CCPs, and then subsequently on 19 December on the adoption of these measures, ESMA began engaging with the European Commission and with UK CCPs to carry out preparatory work for a proposed recognition process. In particular, the European Commission presented the adoption of a time-limited and strictly conditional equivalence decision, which would allow for a temporary recognition by ESMA, in order to ensure that there will be no disruption to central clearing following the UK’s leaving the EU. Consequently, ESMA issued two communications, one after each of the European Commission communications, on 23 November<sup>39</sup> and on 19 December<sup>40</sup> respectively, explaining that it had begun in 2018 engaging with the European Commission, the Bank of England as the competent authority for the UK CCPs and with the UK CCPs to carry

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<sup>38</sup> [https://www.esma.europa.eu/sites/default/files/library/list\\_of\\_applicants\\_tc-ccps.pdf](https://www.esma.europa.eu/sites/default/files/library/list_of_applicants_tc-ccps.pdf).

<sup>39</sup> <https://www.esma.europa.eu/press-news/esma-news/managing-risks-no-deal-brex-it-in-area-central-clearing>

<sup>40</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-ready-review-uk-ccps%E2%80%99-and-csds%E2%80%99-recognition-applications-no-deal-brex-it>



out preparatory work for the recognition process that would ensure that EU Clearing Members and trading venues can continue to access U.K. CCPs as of 30 March, 2019.

## 5.2 On-going monitoring

209. Whilst ESMA does not have, as such, direct supervision powers over TC-CCPs, ESMA has to monitor TC-CCP activity as stated in the ESMA Regulation<sup>41</sup> and in the context of EMIR<sup>42</sup> to ensure EU financial stability. In addition, ESMA should assess whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation.

210. Therefore, following the recognition of a TC-CCP, ESMA has the obligation to regularly monitor the range of activities and services that the TC-CCP provides in the EU to be able to identify potential situations in which the recognition of the CCP should be reviewed. In the context of the CFTC regulated CCPs ESMA also has to monitor the conditions set by the European Commission in the equivalence decision.

211. For example, instead of adopting one of the EMIR Anti-Procyclicality tools CFTC regulated CCPs can choose to adopt equivalent measures, which one of them did. Therefore, to regularly check that equivalence is guaranteed, ESMA receives quarterly updates on the performance of the relevant CFTC regulated CCP regarding the stability and conservativeness of those measures.

212. To perform those monitoring tasks ESMA has decided to focus on the risks that are more likely to materialise and negatively impact the EU financial stability or orderly markets or cause harm to investors.

213. To this end, for recognised TC-CCPs, ESMA has gathered information on interlinkages and exposures of EU entities with the TC-CCP. Leveraging on the CPMI public disclosure framework, ESMA has requested data covering six areas:

- The EU products, currencies and trading venues serviced by the CCP;
- The EU clearing members' activity within the CCP in securities and derivatives (exchange traded and OTC);
- The corresponding EU clearing members' exposures (default contribution, margin provision and power of assessment);

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<sup>41</sup> Recital 43 of Regulation (EU) No 1095/2010 provides that: "In order to safeguard financial stability it is necessary to identify, at an early stage, trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. [ESMA] should monitor and assess such developments in the area of its competence and, where necessary, inform the EP, the Council, the [EC], the other [ESAs] and the ESRB on a regular and, as necessary, on an ad hoc basis."

<sup>42</sup> See, for example, recital 19 of the EC implementing act for Japan which also states that "The [EC], informed by ESMA, should continue monitoring the evolution of the Japanese legal and supervisory framework for CCPs and the fulfilment of the conditions [laid down in Article 25(6) of EMIR] on the basis of which [the] decision has been taken."



- Liquidity resources provided by EU entities to the CCP;
- Interoperability arrangements between the CCP and EU CCPs and
- Qualitative information on important changes at the CCP.

214. Under the relevant MoUs, ESMA has requested the assistance of the third-country authorities to obtain the above-mentioned information. The MoUs stipulate that requests for information should be made in a manner that is consistent with the goal of minimising administrative burdens. With this objective in mind, ESMA will keep on conducting such request for information on a yearly basis, while encouraging the third-country authorities to inform ESMA of any relevant change in the CCP activity as soon as the former becomes aware of it.

215. Further to the necessary steps of reviewing and checking the data received and issuing corresponding follow-up requests, ESMA has conducted its annual analysis on potential risks recognised TC-CCPs might bring to the EU and has identified the areas of monitoring focus for the following years.

## **6 Third-Country Central Counterparties recognition and monitoring work programme for 2019**

216. With regards to UK CCPs, their recognition process as TC CCPs in a no-deal scenario will be ESMA's main priority at the start of 2019. Indeed the work started in 2018 will carry on in 2019, involving the finalisation of a Memorandum of Understanding with the Bank of England and the review and analysis of the respective applications of the UK CCPs.

217. Aside from the UK CCPs, the responsibility of the recognition process of TC-CCPs is an ongoing task for ESMA. In this context, ESMA will assess that the remaining 19 applicant TC-CCPs, or any new applicant, meet the criteria for recognition established in EMIR and any additional condition established in the relevant equivalence decisions. ESMA will also review the recognition of the recognised TC-CCPs in case they extend their range of activities or services in the EU.

218. In the context of initial recognitions or of extensions of range of activities and services, ESMA will assess whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

219. ESMA will also continue to co-operate with third-country authorities and analyse the data received to ensure that TC-CCPs comply on an ongoing basis with the EMIR criteria and equivalence conditions and that the services provided to EU entities do not expose the latter to undue risks.

220. In relation to the results of the data request of 2018, ESMA will keep on monitoring the indicators evaluating whether there are potential risks for the EU emerging from TC-CCP



activity that are not properly addressed through the current schemes and if so, identify the most efficient way to tackle them.

221. The focus is on the level of TC-CCPs clearing activity in EUR and the corresponding share of EU entities and the level of resources provided by EU entities to TC-CCPs and ESMA will share the information received when relevant and permitted with other competent authorities in the EU.

222. Lastly, with respect to the potential regulatory changes to deal with Brexit and with other third countries, ESMA is closely following the legislative developments of EMIR 2.2, although not directly involved in the negotiations. ESMA continues its preparation work in 2019 for taking up the potential new tasks envisaged in the EMIR 2.2 proposal.

## **C. Monitoring and recognition of Central Securities Depositories**

### **7 Monitoring and recognition of Third-Country Central Securities Depositories [NEW]**

#### **7.1 Monitoring and recognition of TC-CSDs in 2018**

##### **Recognition of TC-CSDs**

223. Under CSDR<sup>43</sup>, ESMA recognises TC-CSDs that provide notary or central maintenance services in relation to financial instruments constituted under the law of a Member State or that set up a branch in a Member State. A prerequisite for recognition is the adoption of an equivalence decision by the Commission in respect of the jurisdiction of the TC-CSD. So far, there have been no equivalence decisions published by the European Commission, with the exception for the one published in respect of the UK on 19 December 2018.

224. Following the publication of the equivalence decision by the European Commission in respect of the UK, ESMA started in December 2018 the negotiations to agree on an MoU with the Bank of England as the competent authority for the UK CSD.

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<sup>43</sup> Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.



## **8 Third-Country Central Securities Depositories recognition and monitoring work programme for 2019**

### **8.1 Recognition of TC-CSDs**

225. In 2019, ESMA will pursue the recognition process for the UK CSD which will become a TC-CSD on Brexit day in a no-deal scenario. ESMA will continue the negotiations and sign the corresponding MoU with the Bank of England, as the competent authority for the UK CSD. ESMA will monitor that the recognised TC-CSD complies with the CSDR recognition criteria and with the equivalence conditions, if applicable, on an ongoing basis.

226. Additionally, if applicable, following the adoption by the European Commission of equivalence decisions in respect of other TC-CSDs' jurisdictions, ESMA may need to assess the recognition applications submitted by other TC-CSDs.

### **8.2 On-going monitoring of TC-CSDs**

227. Whilst ESMA does not have, as such, direct supervision powers over TC-CSDs, ESMA has to monitor TC-CSD activity as stated in the ESMA Regulation<sup>44</sup> and in the context of CSDR<sup>45</sup> to ensure EU financial stability.

228. Therefore, following the recognition of a TC-CSD, ESMA has the obligation to regularly monitor the range of activities and services that the TC-CSD provides in the EU to be able to identify potential situations in which the recognition of the CSD should be reviewed.

229. In 2019, ESMA will have to cover at least the monitoring of the UK CSD as a TC-CSD post-Brexit. ESMA will assess that the UK-CSD meets the criteria for recognition established in CSDR and any additional condition established in the relevant equivalence decision. ESMA may also need to review the recognition of the recognised UK CSD in case it extends its range of activities or services in the EU.

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<sup>44</sup> Recital 43 of Regulation (EU) No 1095/2010 provides that: "In order to safeguard financial stability it is necessary to identify, at an early stage, trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. [ESMA] should monitor and assess such developments in the area of its competence and, where necessary, inform the EP, the Council, the [EC], the other [ESAs] and the ESRB on a regular and, as necessary, on an ad hoc basis."

<sup>45</sup> Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.

