

Decision 2020/1

## DECISION OF THE BOARD OF SUPERVISORS

### To adopt supervisory measures and impose fines in respect of infringements committed by Scope Ratings GmbH – (Scope)

**The Board of Supervisors (Board),**

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

**Having regard** to Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), as amended by Regulation (EU) 2019/2175 of 18 December 2019 (“ESMA Regulation”), and Article 43(1) thereof,

**Having regard** to Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies<sup>1</sup>, and in particular Articles 8(3), 8(5)(a), 8(6)(aa), 14(3) third subparagraph, 24 and 36a thereof,

**Having regard** to Commission Delegated Regulation (EU) No 447/2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies<sup>2</sup>, and in particular Article 2 and Article 5(1) thereof, supplementing Article 8(3) of Regulation (EC) No 1060/2009,

**Having regard** to Commission Delegated Regulation (EU) No 946/2012 of 12 July 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to rules of procedure on fines imposed to credit rating agencies by the European

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

<sup>2</sup> OJ L 140 30.05.2012, p. 14

Securities and Markets Authority<sup>3</sup>, including rules on the right of defence and temporal provisions,

**Whereas:**

1. The Supervision Department within ESMA concluded, following preliminary investigations, that with respect to Scope Ratings GmbH (formerly Scope Ratings AG) there were serious indications of the possible existence of facts liable to constitute one or more of the infringements listed in Annex III to Regulation (EC) No 1060/2009.
2. Thus, an independent investigating officer ('IIO') was appointed on 28 March 2018 pursuant to Article 23e (1) of Regulation (EC) No 1060/2009.
3. On 23 April 2018, the decision to appoint the IIO was amended in order to reflect the change in the legal form of Scope Ratings GmbH.
4. On 16 May 2019 the IIO sent her initial Statement of Findings to Scope Ratings GmbH (person subject to investigation, the "PSI"). In her Statement of Findings, the IIO concluded that the PSI committed negligently one or more of the infringements listed in Annex III to Regulation (EC) No 1060/2009.
5. In response to the IIO's initial Statement of Findings, written submissions dated 24 June 2019 were made by Scope Ratings GmbH.
6. Following the receipt of written submissions referred to in point 5 above, the IIO amended her initial Statement of Findings and incorporated those amendments into an amended Statement of Findings, dated 25 July 2019.
7. On 25 July 2019, the IIO submitted to the Board of Supervisors her file relating to Scope Ratings GmbH, which included the initial Statement of Findings dated 16 May 2019, the written submissions made by the entity on 24 June 2019 and the amended Statement of Findings dated 25 July 2019.
8. On 4 November 2019, the Panel established by the Board to assess the completeness of the file submitted by the IIO adopted a ruling of completeness in respect of that file<sup>4</sup>.
9. The Board discussed the case further at its meetings on 3 December 2019, 29 January 2020 and 26 March 2020, when adopted its initial Statement of Findings.
10. On 1 April 2020, on behalf of the Board, ESMA sent the Board's Initial Statement of Findings to Scope Ratings GmbH.

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<sup>3</sup> OJ L 282 16.10.2012, p. 23

<sup>4</sup> Ruling of the Enforcement Panel (ESMA41-356-51)

11. On 22 April 2020 the Board received written submissions on behalf of Scope Ratings GmbH.

12. The Board discussed the case further at its meeting on 28 May 2020.

13. On the basis of the complete file submitted by the IIO containing, *inter alia*, the IIO's findings, and having considered the written submissions made on behalf of Scope Ratings GmbH, the Board found that Scope Ratings GmbH had committed with negligence four of the infringements listed in Annex III of Regulation (EC) No 1060/2009.

14. Pursuant to Article 24 of Regulation (EC) No 1060/2009, where the Board finds that a credit rating agency has committed one of the infringements listed in Annex III, it shall take a supervisory measure, taking into account the nature and seriousness of the infringement.

15. Pursuant to Article 36a of Regulation (EC) No 1060/2009, where the Board finds that a credit rating agency has, intentionally or negligently, committed one of the infringements listed in Annex III, it shall adopt a decision imposing a fine.

**HAS ADOPTED THIS DECISION:**

### **Article 1**

#### ***Infringements***

Scope Ratings GmbH negligently committed the following infringements:

1. the infringement set out at Point 43 of Section I of Annex III of Regulation (EC) No 1060/2009;
2. the infringement set out at Point 3a of Section II of Annex III of Regulation (EC) No 1060/2009;
3. the infringement set out at Point 3b of Section II of Annex III of Regulation (EC) No 1060/2009;
4. the infringement set out at Point 4a of Section III of Annex III of Regulation (EC) No 1060/2009;

for the reasons stated in the Annex I to this Decision.

### **Article 2**

#### ***Public Notice***

The Board of Supervisors of ESMA adopts a supervisory measure in the form of a public notice to be issued in respect of the infringement referred to in Article 1. The text of the public notice is provided in Annex II to this Decision.

### **Article 3**

#### ***Fines***

The Board of Supervisors of ESMA imposes on Scope Ratings GmbH the following fines, as calculated in Annex I to this Decision:

EUR 550 000 for the infringement set out at Point 43 of Section I of Annex III of the Regulation;

EUR 90 000 for the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III, since the Board considers that the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III are constituted by the same act. In accordance with Article 36a(4) of the Regulation, only the highest fine of EUR 90 000 related to the infringement of Point 4a of Section III of Annex III is applicable in this case regarding these three infringements;

for the overall amount of EUR 640 000.

### **Article 4**

#### ***Remedies***

Scope Ratings GmbH may avail itself of the remedies of Chapter V of Regulation (EU) No 1095/2010 against this Decision.

### **Article 5**

#### ***Addressee***

This Decision is addressed to **Scope Ratings GmbH** – Lennéstraße 5, 10785 Berlin.

### **Article 6**

#### ***Entry into force***

This Decision shall enter into force on the date of its adoption.

Done at Paris, on 28 May 2020

*[PERSONAL SIGNATURE]*

*For the Board of Supervisors*

*Steven Maijoor*

*The Chair*

## ANNEX I

### STATEMENT OF FINDINGS OF THE BOARD OF SUPERVISORS

1. The Board notes that on 1 April 2020 ESMA sent the Board's Initial Statement of Findings dated 26 March 2020 to Scope Ratings GmbH.
2. By email dated 22 April 2020, written submissions, including an academic opinion, were provided on behalf of the PSI.
3. In the submissions, the PSI asked the Board to reverse its initial findings, dismissing any sanction. The Board notes that the submissions reiterate some of (but not all) the defensive arguments already thoroughly analysed by the Board in preparation of the initial Statement of Findings. Moreover, the Board notes that the written submissions also present partially new objections, developed on the basis of the academic opinion.
4. The written submissions have been carefully considered by the Board, together with the content of the academic opinion and with any other submissions previously made by the PSI.
5. Having considered the amended version of the Statement of Findings of the IIO, the written submissions made on behalf of the PSI in relation to this matter and the material in the IIO's file, the Board sets out its findings and the reasons for its findings below.

### EXECUTIVE SUMMARY

6. Scope Ratings GmbH (formerly Scope Ratings AG – from now on 'Scope', or the Person Subject to Investigation "PSI") is a German-based CRA, registered since 24 May 2011, with branch offices in the UK, Italy, France and Norway. It is considered as an important CRA for a combination of increase in physical geographical footprint, rise in revenues, number of staff, organisational complexity and rating issuances.

**Scope Ratings GmbH negligently committed the infringement set out at Point 43 of Section I of Annex III of the Regulation by not having applied the 2015 Covered Bond Methodology in a systematic way.**

7. According to Article 8(3) of the Regulation, a credit rating agency ("CRA") must use rating methodologies that are systematic.
8. In order to ensure transparency in the assessment carried out by ESMA, Article 5(1) of the Delegated Regulation No 447/2012 clarifies that "the credit rating agency shall use a credit rating methodology and its associated analytical models, key credit rating assumptions and

criteria that are applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it”.

9. In 2015, Scope Ratings GmbH adopted a Covered Bond Methodology, which foresaw, in addition to an analysis of the issuer credit strength, an analysis constituted of two further elements: the first building block consisted of the analysis of the legal framework and the resolution regime, whereas the second building block consisted of the analysis of the cover pool. The 2015 Covered Bond Methodology also specified that a thorough analysis of the cover pool had to be performed for all rated covered bonds.
10. The 2015 Covered Bond Methodology was applied by Scope Ratings GmbH for issuing ratings to 17 covered bond programmes, which amounted to a total of 622 ratings. The cover pool was only analysed in two of these covered bond programmes. On the contrary, the ratings issued in September and November 2015 did not comprise the type of analysis of the cover pool which was foreseen by the 2015 Covered Bond Methodology.
11. The Board therefore finds that the 2015 Covered Bond Methodology was not applied systematically.
12. In addition, the Board finds that there were no objective reasons for divergence from the systematic application of the 2015 Covered Bond Methodology.
13. Furthermore, the Board notes that the ratings without the foreseen cover pool analysis constitute 559 ratings out of the 622 ratings which were assigned on the basis of the 2015 Covered Bond Methodology, i.e. they were not an exception in terms of figures.
14. Consequently, on the basis of the assessment of the complete file submitted by the IIO, containing, *inter alia*, the IIO's findings and having considered the written submissions made by the PSI, the Board finds that Scope Ratings GmbH failed to comply with the requirement of Article 8(3) of the Regulation, and committed the infringement set out at Point 43 of Section I of Annex III of the Regulation.
15. Moreover, on the basis of specific evidence, Scope Ratings GmbH must be considered to have acted negligently (but not intentionally) when it committed the infringement.
16. The Board has calculated the basic amount of the fine pursuant to Article 36a) of the Regulation, which, *inter alia*, takes into account the size of the CRA.
17. In addition, the Board has applied the relevant aggravating (the infringement has been committed for more than six months) and mitigating (the CRA has voluntarily taken measures to ensure that a similar infringement cannot be committed in the future) factors prescribed by Annex IV of the Regulation and has therefore fined Scope EUR 550 000.
18. Furthermore, the infringement requires the adoption of a supervisory measure taking the form of a public notice.

**Scope Ratings GmbH negligently committed the infringements:**

- set out at Point 3a of Section II of Annex III of the Regulation by not having notified ESMA of the intended material changes to the 2015 Covered Bond Methodology;
  - set out at Point 3b of Section II of Annex III of the Regulation by not having published on its website the proposed material changes to the 2015 Covered Bond Methodology; and
  - set out at Point 4a of Section III of Annex III of the Regulation by not having informed ESMA and not having published immediately on its website the results of a consultation about the 2015 Covered Bond Methodology.
19. According to the Regulation, when a CRA intends to make material changes to any of its rating methodologies, it must publish the proposed material changes on its website, inviting stakeholders to submit comments for a period of one month, together with a detailed explanation of the reasons for and the implications of the proposed material changes. The CRA must also notify ESMA of the intended material changes to the rating methodologies when it publishes the proposed changes on its website and after the expiry of the consultation period, notify ESMA of any changes due to the consultation. Finally, where a CRA changes any of its rating methodologies, it must immediately inform ESMA and publish on its website the results of the consultation and the new rating methodology together with a detailed explanation thereof and its date of application.
20. In 2016, Scope Ratings GmbH introduced changes to its Covered Bond Methodology. However, Scope Ratings GmbH did not publish on its website the proposed material changes and did not invite stakeholders to submit comments for a period of one month; it was therefore unable to publish on its website the results of this consultation; it also did not notify ESMA of the intended material changes at the time of the consultation and did not notify ESMA of changes due to this consultation.
21. Scope Ratings GmbH argued that the requirements of the Regulation were not applicable because it considered that the changes in 2016 were not material, as they did not in practice impact any existing ratings.
22. On the contrary, the Board believes that the mere fact that no existing rating would be impacted cannot per se exclude the materiality of the changes for the purposes of the Regulation. A change could be material even if no existing rating is impacted and if there could have been only a potential impact.
23. The nature of the changes has to be assessed on a case-by-case basis to determine whether they are material. In practice, the changes introduced in 2016 to the Covered Bond Methodology did modify the way in which an assessment of the cover pool had to be performed under this methodology.

24. Therefore, the Board finds that the changes introduced in 2016 to the 2015 Covered Bond Methodology were material.
25. Consequently, on the basis of the assessment of the complete file submitted by the IIO, containing, *inter alia*, the IIO's findings and having considered the written submissions made on behalf of Scope, the Board finds that Scope Ratings GmbH breached the requirements of Articles 8(5a), 8(6) and 14(3), third subparagraph, of the Regulation, and thus committed the infringements set out at Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation.
26. In addition, on the basis of specific evidence, Scope Ratings GmbH must be considered to have acted negligently (but not intentionally) when it committed the infringements.
27. The basic amount of the fine was calculated pursuant to Article 36a) of the Regulation, which, *inter alia*, takes into account the size of the CRA. Therefore:
28. the fine to be imposed for the negligent infringement set out at Point 3a of Section II of Annex III of the Regulation amounts to EUR 25 000 (there being no applicable aggravating or mitigating factors).
29. The fine to be imposed for the negligent infringement set out at Point 3b of Section II of Annex III of the Regulation amounts to EUR 25 000 (there being no applicable aggravating or mitigating factors).
30. The fine to be imposed for the negligent infringement set out at Point 4a of Section III of Annex III of the Regulation amounts to EUR 90 000 (there being no applicable aggravating or mitigating factors).
31. Nevertheless, the Board considers that these infringements stem from the same acts and omissions: namely, the fact that Scope Ratings GmbH had considered the changes to the 2015 Covered Bond Methodology to be non-material is at the origin of the three infringements. Thus the Board finds that Article 36a(4) of the Regulation is applicable and in line with this provision, and considers applicable only the highest fine of EUR 90 000 related to the infringement of Point 4a of Section III of Annex III.
32. Furthermore, the infringements require the adoption of a supervisory measure taking the form of a public notice.



### **The Board has considered the following facts:**

33. The PSI is a German-based credit rating agency with branch offices in the UK, Italy, France and Norway<sup>5</sup>.
34. The PSI is registered as a CRA since 24 May 2011<sup>6</sup>. More precisely, PSR Rating was registered by the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) on 24 May 2011<sup>7</sup> and in January 2012, Scope Holding GmbH took over the shares of PSR Rating and renamed it<sup>8</sup>.
35. The PSI is considered as an important CRA, for a combination of increase in physical geographical footprint, rise in revenues, number of staff, organisational complexity and rating issuances.
36. As regards the financial year that ended 31 December 2017, the PSI's total turnover was EUR 4 106 445 and the revenues derived from rating activities were EUR 3 917 788<sup>9</sup>; it employed 45.5 employees<sup>10</sup>.
37. In 2018, the PSI's total revenues approximately doubled (EUR 8 136 361 from rating activities and EUR 65 934 from ancillary services)<sup>11</sup> and it employed 56 persons<sup>12</sup>.
38. According to the latest PSI's Transparency Report, the PSI's total revenues further increased in 2019, amounting to EUR 9 786 285.
39. According to its website, the PSI has more than 20 rating methodologies<sup>13</sup>.
40. The PSI is fully owned by Scope SE&Co. KGaA<sup>14</sup>, whose majority shareholder is Schoeller Corporation GmbH<sup>15</sup>. The PSI is part of a group that also comprises: Scope Risk Solutions GmbH, Scope Analysis GmbH and Scope Investor Services GmbH<sup>16</sup>.
41. On 1 August 2016, Scope SE&Co. KGaA acquired FERI EuroRating Services AG ("FERI") and transferred its sovereign rating business to the PSI and the non-credit rating business

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<sup>5</sup> Exhibit 23, Transparency Report 2018, p. 3.

<sup>6</sup> See Exhibit 24, ESMA's list of registered or certified credit rating agencies.

<sup>7</sup> Supervisory Report, Exhibit 33, 20110524102216426. To be noted that the registration decision does not provide for any exemptions under Article 6(3) of the Regulation to the requirements of the Regulation, in particular no exemption regarding the review function.

<sup>8</sup> Supervisory Report, Exhibit 32, 070 01 20120116\_Joining forces PSR SCOPE.

<sup>9</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 1. The figures provided in the response to the IIO's First RFI represent Scope Rating's revenues for 2017 after the yearly audit. The difference with the figures provided in the Transparency Report for 2017 (Exhibit 25, p. 7) is related to the accounting rules used to draw the accounts. While the figures in the Transparency Report for 2017 were based on the German accounting standards, the figures provided by the PSI in response to the IIO's First RFI are based on the International Financial Reporting Standards (IFRS). See Exhibit 14, PSI's Response to the IIO's Second RFI, Question 1.

<sup>10</sup> Exhibit 25, Transparency Report 2017, p. 5.

<sup>11</sup> Exhibit 19, PSI's Response to the IIO's Third RFI, Question 1.

<sup>12</sup> Exhibit 23, Transparency Report 2018, p. 5.

<sup>13</sup> See Exhibit 26, Scope's list of methodologies.

<sup>14</sup> Exhibit 23, Transparency Report 2018, p. 8.

<sup>15</sup> Exhibit 23, Transparency Report 2018, p. 8.

<sup>16</sup> See Exhibit 27, Scope's legal structure.

activities to Scope Analysis GmbH<sup>17</sup>. On 29 March 2017, ESMA withdrew FERl's registration after the PSI notified FERl's intention to be deregistered<sup>18</sup>.

42. On 24 January 2018, the PSI changed its legal form from AG (*Aktiengesellschaft*) to GmbH (*Gesellschaft mit beschränkter Haftung*)<sup>19</sup>.

#### **PSI's relevant internal policies regarding the development, approval and review of methodologies**

43. The PSI has a specific internal policy regarding the development, approval and review of rating methodologies (the "Validation Policy"). The Validation Policy was adopted in July 2014<sup>20</sup> (the "2014 Validation Policy") and since then, it has been updated on 7 different occasions: on 7 July<sup>21</sup> and 10 October<sup>22</sup> 2016 (the "2016 Validation Policies"), in January<sup>23</sup>, in July<sup>24</sup> and August<sup>25</sup> 2017 (the "2017 Rating Methodologies Process Manuals"), in February<sup>26</sup> and March 2018<sup>27</sup> (the "2018 Rating Methodologies Process Manuals"), and in April 2019<sup>28</sup> (the "2019 Rating Methodologies Process Manual").

44. It is noted that the name of the Validation Policy has evolved throughout the years:

45. The original name of the Validation Policy was "*Validation Process for Rating Methodologies*"<sup>29</sup>;

46. In July 2016, it was changed to "Policy for the Approval, Review and Validation of Rating Methodologies"<sup>30</sup>; and

47. In the January 2017 update, the name of the Validation Policy was changed to "*Rating Methodologies Process Manual*"<sup>31</sup>. This is the current name of the Validation Policy<sup>32</sup>.

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<sup>17</sup> Supervisory Report, Exhibit 30, Transparency\_Report\_2016, p. 3.

<sup>18</sup> Supervisory Report, Exhibit 54, 54\_esma71-99-376\_ferl\_eurorating\_services\_credit\_rating\_agency\_registration\_withdrawn.

<sup>19</sup> Exhibit 28, HRB.

<sup>20</sup> Supervisory Report, Exhibit 7, IV\_Validation policy.

<sup>21</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 30.

<sup>22</sup> Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 30.

<sup>23</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016.

<sup>24</sup> Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow.

<sup>25</sup> Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17.

<sup>26</sup> Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018.

<sup>27</sup> Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual.

<sup>28</sup> Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings Rating Methodologies Process Manual April 2019".

<sup>29</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p.1.

<sup>30</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p.1.

<sup>31</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p.1.

<sup>32</sup> Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings Rating Methodologies Process Manual April 2019", p.1.

48. According to the 2014 Validation Policy, the PSI “pursues a rigorous and systematic process for the validation and approval of new rating methodologies and the review of existing methodologies<sup>33</sup>”.

49. The Validation Policy <sup>34</sup> describes the main steps involved, which can be broadly summarised as follows:

- Initiation of the methodology development (for example, by the review function or a team head);
- Drafting and discussion of a methodology proposal;
- Discussion within a committee;
- Inclusion of internal comments and approval by the committee;
- Approval by the review function;
- Publication of the methodology proposal on the website and call for comments;
- Discussion of the comments received;
- Adoption and publication of the methodology.

50. **[omitted due to confidentiality]**

51. **[omitted due to confidentiality]**

52. It is also noted that the 2014 Validation Policy indicated that the PSI “applies the same process to the validation of a new methodology and to the review of existing methodologies” and did not distinguish between material and non-material changes<sup>35</sup>.

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<sup>33</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p.2.

<sup>34</sup> Supervisory Report, Exhibit 7, IV\_Validation policy; Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”.

<sup>35</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p. 2.

53. All subsequent policies make the distinction<sup>36</sup> and some steps of the validation process are then only applicable when the changes introduced are considered to be material<sup>37</sup>. The review function has the final say in assessing whether a change to a rating methodology is material<sup>38</sup>.
54. In the 2016 Validation Policies, material changes were defined as “changes that would impact existing ratings or substantial changes of a key rating factor<sup>39</sup>”. This definition was amended in the subsequent versions<sup>40</sup>.
55. The 2017 Rating Methodologies Process Manuals and subsequent policies also included illustrative examples of what the PSI considers as non-material change<sup>41</sup>. In the 2017 Rating Methodologies Process Manual, non-material changes are said to include: “editorial changes, clarification of the description of rating factors and the addition of appendices to

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<sup>36</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p. 3; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p. 3; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 3; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p. 4; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 4; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 5; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 5; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p. 5.

<sup>37</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p. 3; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p. 3; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 6; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p. 6; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 7; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 8; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 8; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, pp. 8-9.

<sup>38</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p. 3; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p. 3; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 3; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow p. 4; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 4; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 5; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 5; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p. 5.

<sup>39</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p. 3; and Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p. 3.

<sup>40</sup> In the 2017 Rating Methodologies Process Manuals, material changes were defined as “substantial changes to one or more key rating factor(s) or their weight where applicable, to a model or to key rating assumptions or changes that impact already assigned ratings”, See Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 3; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p. 4 and Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 4. In the 2018 Rating Methodologies Process Manuals, the reference to “a model” has been replaced by a reference to “a quantitative tool”, See Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 5; and Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 5. In the 2019 Rating Methodologies Process Manual, the reference to “quantitative tools” in the definition of material changes has also been eliminated: Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p. 5.

<sup>41</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 3; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p. 4; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 4; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 5; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 5; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p. 5.

provide greater transparency<sup>42</sup>". The 2018 Rating Methodologies Process Manuals and the 2019 Rating Methodologies Process Manual have included another item to that list: "changes to the methodology itself which do not bear on any key rating driver or key assumption<sup>43</sup>". Finally, all the different versions of the Validation Policy provide that when changes are introduced to a given methodology, an impact study on existing ratings should be conducted, in order to assess the scope and magnitude of the impact of the proposed changes to the rating methodology<sup>44</sup>.

#### **Development and approval of the 2015 CB Methodology**

56. The PSI published its first Covered Bond ("CB") rating methodology on 3 July 2015<sup>45</sup> (the "2015 CB Methodology").

57. On the basis of the information collected throughout the investigation, the main steps of the development and approval of the 2015 CB Methodology can be summarised as follows:

58. The project started in 2014 to develop master criteria to rate cover bonds<sup>46</sup>.

59. [omitted due to confidentiality]

60. [omitted due to confidentiality]

61. [omitted due to confidentiality]

62. [omitted due to confidentiality]

63. [omitted due to confidentiality]

64. [omitted due to confidentiality]

65. [omitted due to confidentiality]

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<sup>42</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 3; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p. 4; and Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 4.

<sup>43</sup> Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 5; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 5; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings Rating Methodologies Process Manual April 2019", p. 5.

<sup>44</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p. 2; Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p. 3; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p. 3; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p. 4; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p.5; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p. 5; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p. 6; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p. 6; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings Rating Methodologies Process Manual April 2019", p. 6.

<sup>45</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology.

<sup>46</sup> Supervisory Report, Exhibit 112, XXIV\_Covered bond criteria project\_Working docs v1.0\_Criteria outlines.

66. The proposed new CB methodology was approved for publication on 11 February 2015<sup>47</sup>. The same day, the IRF informed ESMA about the PSI's intention to publish the proposed new methodology for consultation on 12 February 2015<sup>48</sup>.
67. On 12 February 2015, the PSI issued a press release<sup>49</sup> informing about the publication of the new CB methodology and about the possibility for market participants to submit comments until 3 April 2015. The press release contained information about a public conference call and a link to the proposed CB methodology<sup>50</sup>.
68. A public conference call took place on 26 February 2015 to discuss the proposed CB methodology. ESMA's Supervision Department participated and asked questions regarding the modelling aspects of the proposed CB methodology. In this regard, a follow-up conference call with ESMA took place on 10 March 2015<sup>51</sup>.
69. A number of stakeholders provided comments on the proposed CB methodology<sup>52</sup>.
70. On 25 June 2015, the committee unanimously decided to convert the proposed new CB methodology into the final CB methodology. The IRF participated in this committee as a voting participant<sup>53</sup>.
71. On 3 July 2015, the final CB methodology was approved for publication<sup>54</sup> and the IRF notified ESMA<sup>55</sup>.
72. The publication of the final CB methodology<sup>56</sup> took place on 3 July 2015. On the same day, the PSI issued a press release<sup>57</sup> including a link to the methodology as well as a link to the summary of comments received during the call for comments and the resulting clarifications/modifications to the methodology<sup>58</sup>.

#### **Content of the 2015 CB Methodology, in particular regarding the analysis of the cover pool**

73. According to the 2015 CB Methodology "sets the framework for the rating assessment and regular monitoring of covered bonds<sup>59</sup>" and it "applies to all covered bonds that benefit from a dual recourse to both a financial institution and a ring-fenced cover pool<sup>60</sup>". The PSI

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<sup>47</sup> Supervisory Report, Exhibit 94, XI\_Covered Bond Rating Methodology - ready to go.

<sup>48</sup> Supervisory Report, Exhibit 93, X\_20150211 APT to ESMA Notification of Proposed Methodology for Rating Covered Bonds.

<sup>49</sup> Supervisory Report, Exhibit 95, XII\_20150212\_Scope press release covered bond rating methodology\_Call for comments.

<sup>50</sup> Supervisory Report, Exhibit 96, XIII\_20150212\_Scope Ratings\_Covered bond rating methodology\_Call for comments.

<sup>51</sup> Supervisory Report, Exhibit 88, XXX\_1144\_20150310\_Memo conf call ESMA scope validation covered bond methodology.

<sup>52</sup> Supervisory Report, Exhibit 101, XLV\_20150703\_Scope CB methodology\_Formal call for comment responses.

<sup>53</sup> Supervisory Report, Exhibit 46, XXXII\_1146\_20150703\_Covered bond criteria CMT\_conversion of CfC into final criteria\_Post cmt documentation, p.1.

<sup>54</sup> Supervisory Report, Exhibit 11, XVII\_20150703 Approval to publish by CHAIR (GJ).

<sup>55</sup> Exhibit 40, PSI's Response to the IIO's First RFI, Document 62, RE Final Covered Bond Rating Methodology.

<sup>56</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology.

<sup>57</sup> Supervisory Report, Exhibit 105, XVI\_20150703\_Scope Ratings\_Press release final covered bond criteria.

<sup>58</sup> Supervisory Report, Exhibit 107, XVIII\_Covered bond call for comment summary report.

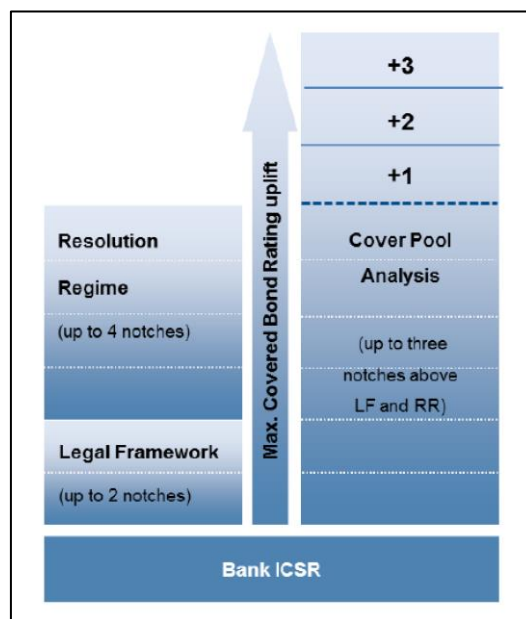
<sup>59</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.3.

<sup>60</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.3.



indicated that this is the case irrespective of whether the covered bond ratings are solicited or not<sup>61</sup>.

74. According to the 2015 CB Methodology, covered bonds “reflect the probability of insolvency of both the issuer and the cover pool, and the associated expected loss<sup>62</sup>”.
75. In the 2015 CB Methodology, the Issuer Credit Strength Rating (“ICSR”) is the fundamental anchor point of the credit rating<sup>63</sup>. The final rating is, however, further supported by the analysis of the legal framework and regulatory regime (first recourse) and the cover pool (second recourse), which together can support a credit differentiation between the issuer’s ICSR and the covered bond’s rating of up to nine notches<sup>64</sup>. The cover pool and the legal framework and resolution regime can only uplift the value of the ICSR and cannot set the final rating at a level lower than the ICSR<sup>65</sup>.
76. In order to determine whether an uplift from the ICSR could be supported, the 2015 CB Methodology uses a “building block” approach:



*Figure provided by the PSI in its 2015 CB Methodology<sup>66</sup>:  
Building blocks of Scope's covered bond methodology*

<sup>61</sup>Supervisory Report, Exhibit 6, Response Annex ESMA Rfl\_11 Nov\_final\_clean, 11 November 2016, p. 8: “The rating process for assigning and monitoring unsolicited versus solicited covered bond ratings does not differ”.

<sup>62</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.

<sup>63</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.4.

<sup>64</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.17: “The cover pool analysis supports a possible credit differentiation between the issuer’s ICSR and the covered bond of up to nine notches, not only three notches”.

<sup>65</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 5: “Scope’s covered bond rating is closely linked to the ICSR of the bank issuer – but is generally higher”.

<sup>66</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 4.

77. The final credit differentiation between the ICSR and the covered bond is determined based on the higher support provided by either of the two building blocks<sup>67</sup>.
78. The first building block consists of the analysis of the legal framework and the resolution regime<sup>68</sup>. Together the legal framework and the resolution regime are considered the most important supporting elements for the covered bond rating<sup>69</sup> and can provide an uplift of up to 6 notches above the ICSR<sup>70</sup> (2 notches for the legal framework<sup>71</sup> and 4 notches for the resolution regime<sup>72</sup>).
79. The second building block consists of the analysis of the cover pool<sup>73</sup>. According to the 2015 CB Methodology, “a thorough analysis of the cover pool needs to be performed for all rated covered bonds<sup>74</sup>” and “Scope performs and publishes a detailed quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers<sup>75</sup>”. The Board notes that the 2015 CB Methodology does not provide any definition as to what constitutes a “highly rated issuer” or a “lowly rated issuer”. In its response to the request for information from ESMA’s Supervision Department of 30 September 2016, the PSI clarifies that “highly rated issuers” are typically A- and above<sup>76</sup>.
80. The Board also notes that under the 2015 CB Methodology “The benefit of the cover pool is limited but it provides additional security and stability to the rating<sup>77</sup>”. As indicated in the minutes of the 2015 CB Methodology Committee, “even though highly rated banks will be able to achieve the highest rating without the benefit of the cover pool, we believe a quantitative analysis of the cover pool in general also needs to be performed for these programs<sup>78</sup>”.
81. On its own, the analysis of the cover pool can support an uplift of up to 9 notches above the ICSR<sup>79</sup>, which means that it can support an uplift of up to 3 notches above the 6-notch uplift that can be provided by the legal framework and the resolution regime<sup>80</sup>.
82. The cover pool analysis seeks to understand the credit and cash-flow risks a covered bond is exposed to<sup>81</sup>. In particular, the PSI performs an asset credit risk analysis and applies the results of it to a cash-flow analysis<sup>82</sup>.

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<sup>67</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 17.

<sup>68</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 17.

<sup>69</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, pp. 3 and 4.

<sup>70</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 3.

<sup>71</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 7.

<sup>72</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 9.

<sup>73</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 17.

<sup>74</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 9.

<sup>75</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 5.

<sup>76</sup> Supervisory Report, Exhibit 6\_Response Annex ESMA RfI\_11Nov\_final\_clean, p.6.

<sup>77</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.4.

<sup>78</sup> Supervisory Report, Exhibit 58, XXV\_1140\_20150128\_Covered bond methodology committee – Final, p.7.

<sup>79</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.17.

<sup>80</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.9.

<sup>81</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.9.

<sup>82</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.9.



83. According to the 2015 CB Methodology, in order to capture the risk of different collateral pools, the PSI applies “a methodological framework that allows consistent modelling across asset classes with collateral of various granularities and homogeneities<sup>83</sup>”. Depending on the characteristics of the cover pool, the PSI relies on the following:
84. For concentrated cover pools with limited diversification, it relies on market-standard Monte Carlo simulation models<sup>84</sup>;
85. For homogeneous, granular cover pools, it relies on the LHPA [Large Homogeneous Portfolio Approximation] approach<sup>85</sup>; and
86. For mixed covered pools, it combines the different analytical frameworks<sup>86</sup>.
87. Furthermore, regarding the cash flow analysis, the 2015 CB Methodology provides that “we determine the scheduled cash flows based on the cover pool assets, outstanding covered bonds and related derivatives, while also taking available overcollateralization into account. We then apply stresses to the asset and market<sup>87</sup>”.

#### **Application of the 2015 CB Methodology**

88. The 2015 CB Methodology was applied by the PSI for issuing ratings to 17 covered bond programmes<sup>88</sup> (15 unsolicited and 2 solicited).
89. At the instrument level, this corresponds to the assignment of 622 ratings under the 2015 CB Methodology (559 unsolicited and 63 solicited)<sup>89</sup>. Details are provided below.
90. The first batch of CB ratings were issued by the PSI<sup>90</sup> on 22 September 2015. The PSI assigned AAA/Stable ratings to European covered bonds from 9 issuers<sup>91</sup>.

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<sup>83</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.10.

<sup>84</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.10.

<sup>85</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.10.

<sup>86</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.10.

<sup>87</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.11.

<sup>88</sup> Supervisory Report, Exhibit 3, 2015-09-23 Scope Assigns Unsolicited Covered Bond Ratings to 9 issuers- v3, p.1; See also Exhibit 14, PSI's Response to the IIO's Second RFI, Question 2.

<sup>89</sup> Exhibit 14, PSI's Response to the IIO's Second RFI, Question 2. The PSI indicated that “Once a rating is assigned to a covered bond programme, it can be applied to all the instrument level issuances drawn thereunder”.

<sup>90</sup> Supervisory Report, Exhibit 63, 65F\_W Discuss 1st batch of Covered bond ratings form common understanding and identify roadblocks.

<sup>91</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating.

91. These ratings were all unsolicited and the methodologies used for the assessment were the 2015 CB Methodology and the General Structured Finance Rating Methodology published on 28 August 2015<sup>92</sup>.
92. More details on these ratings are included in Annex 1.
93. All these ratings were driven by the issuer's ICSR and the PSI's assessment of the legal framework and regulatory regime<sup>93</sup>. The assessment of the legal framework and regulatory regime supported the maximum credit differentiation from the ICSR that according to the 2015 CB Methodology, they could provide (i.e. 6 notches above the ICSR)<sup>94</sup>.
94. In the relevant press releases, while the PSI briefly described the composition of the different cover pools, it clarified that it did not analyse the cover pools<sup>95</sup>. According to the PSI, this is due to the fact that "sufficient data [was] not publicly available to perform a rating analysis of the available collateral and cash flow structures<sup>96</sup>".
95. Not all the ratings issued by the PSI on 22 September 2015 benefited from a "rating buffer"<sup>97</sup>. The Board acknowledges that, in those cases where there was no rating buffer<sup>98</sup>,

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<sup>92</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p. 4; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p. 4; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release, p. 3; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, p.4. Please also see Exhibit 11, PSI's Response to the IIO's First RFI, Question 8, for an explanation of why the General Structured Finance Rating Methodology was indicated.

<sup>93</sup> Supervisory Report, Exhibit 3, 2015-09-23 Scope Assigns Unsolicited Covered Bond Ratings to 9 issuers- v3, p. 1; Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p. 1; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p. 1; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release, p. 1; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, p.1.

<sup>94</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p. 1; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p. 1; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release, p. 1; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, p.1.

<sup>95</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p. 2; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p. 2; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release, p. 2; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, pp. 2-3; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, pp. 2-3; See also Supervisory Report, Exhibit 62, III\_20150917\_BBVA\_Post committee memo, p. 1: "current proposed ratings are solely based on the fundamental support covered bonds received in those countries and does not include any potential additional benefit the cover pool analysis may be able to support (up to three additional notches)".

<sup>96</sup> Supervisory Report, Exhibit 3, 2015-09-23 Scope Assigns Unsolicited Covered Bond Ratings to 9 issuers- v3, p.1.

<sup>97</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release, p.2.

<sup>98</sup> On this concept of "rating buffer", see for example Supervisory Report, Exhibit 111, XXIII\_Covered bond criteria\_Draft v2 4\_For methodology CMT Feb 27 2015\_Including cmt deliberations and votes, p. 18: "Typically a rating change of the ICSR or a

a negative development of the issuer rating (or the issuer outlook) could have affected the rating of the covered bonds<sup>99</sup>, because there were no unused notches. In such scenario, according to the discussions held on 17 September 2015 between the members of the credit rating committee, the PSI “[would] discuss on an individual basis whether it is likely that the covered bonds cannot support a further uplift over and above the fundamental support (...)”<sup>100</sup>.

#### Unsolicited ratings of 26 November 2015

96. On 26 November 2015, the PSI assigned AAA long-term ratings to covered bonds issued by 3 Swedish banks<sup>101</sup>.
97. The methodologies used for the ratings were the 2015 CB Methodology and the 2015 General Structured Finance Rating Methodology<sup>102</sup>.
98. Like the previous CB ratings, these ratings were all unsolicited<sup>103</sup> and the PSI did not analyse the cover pool<sup>104</sup>.
99. The ratings assigned to Swedbank AB did not benefit from a rating buffer<sup>105</sup>. According to the discussions held by the credit rating committee on 24 November 2015, “in case of a downgrade or change in the outlook for Swedbank and Swedbank Mortgage [the PSI] would need to seek for additional information on the cover pool which potentially could then still support the currently proposed ratings<sup>106</sup>”.
100. More details on these ratings are included in Annex 2.

#### Solicited rating of 4 May 2016

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placement of the ICSR “under review” will prompt a corresponding review of the covered bond ratings – unless the cover pool is able to buffer for a potential downgrade”.

<sup>99</sup> See Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.2; and Supervisory Report, Exhibit 73, Deutsche Bank’s mortgage covered bonds press release, p. 2: “A negative development of the issuer rating or the outlook could impact the rating of the covered bonds if the additional benefit of the cover pool analysis – which could provide an additional credit support of up to three notches – is not taken into account. Based only on the fundamental supporting factors there is no rating buffer available”. See also Supervisory Report, Exhibit 62, III\_20150917\_BBVA\_Post committee memo.

<sup>100</sup> Supervisory Report, Exhibit 62, III\_20150917\_BBVA\_Post committee memo, p.3.

<sup>101</sup> Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating; Supervisory Report, Exhibit 25 I, 20151126\_Swedbank Mortgage\_Press release\_Initial rating.

<sup>102</sup> Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p.4; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, p.4. Please also see Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 8, for an explanation of why the General Structured Finance Rating Methodology was indicated.

<sup>103</sup> Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, p.3.

<sup>104</sup> Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, p.2.

<sup>105</sup> Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, p.3.

<sup>106</sup> Supervisory Report, Exhibit 74, 20151124 Swedish CBs Unsolicited CB Ratings - Rating Memo for CMT, p. 5.

101. On 4 May 2016, the PSI assigned an AA-/Stable rating to Dexia Kommunalbank Deutschland AG (Dexia)'s public sector covered bonds<sup>107</sup>. This rating was a solicited private rating turned public<sup>108</sup>.
102. The rating reflected the PSI's analysis of the legal framework and the resolution regime (which supported a 5-notch credit differentiation) as well as its analysis of the cover pool (which supported a 6-notch credit differentiation)<sup>109</sup>.
103. To analyse Dexia's public-sector covered bonds, the PSI applied in particular the 2015 CB Methodology and the principles as per its 2015 General Structured Finance Rating methodology for the asset and cash flow analysis<sup>110</sup>.
104. According to the rating report, the PSI "analysed the cover pool and its cash flows as of December and June 2015<sup>111</sup>". The PSI used a bespoke portfolio analysis tool and a bespoke cash flow tool coded in python<sup>112</sup> for its cover pool analysis<sup>113</sup>. It assessed the credit quality and distribution of the cover pool assets<sup>114</sup>. It also analysed its cash flow characteristics (including market risk exposure, asset liability mismatch risk and overcollateralisation)<sup>115</sup> and the counterparty risk<sup>116</sup>. Appendix II to the rating report on Dexia's public sector covered bonds provides technical information on the PSI's covered bond portfolio credit risk and cash flow modelling<sup>117</sup>.

#### Solicited rating of 8 July 2016

105. On 8 July 2016, the PSI assigned an AAA/Stable rating to Bankia SA's mortgage covered bonds<sup>118</sup>. The credit rating was a solicited private rating turned public<sup>119</sup>.

<sup>107</sup> Exhibit 41, Supervision Department's Response to the IIO, Document 1, 2g I\_20151126\_Dexia Kommunalbank\_Press release\_Initial rating.

<sup>108</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, see p.1 and p.20.

<sup>109</sup> Exhibit 41, Supervision Department's Response to the IIO, Document 1, 2g I\_20151126\_Dexia Kommunalbank\_Press release\_Initial rating, p.1; and Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, p.1.

<sup>110</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, p.12.

<sup>111</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, p.3.

<sup>112</sup> Python is a programming language which incorporates modules, exceptions, dynamic typing, dynamic data types, and classes. For further information please see: Exhibit 43, Python FAQ.

<sup>113</sup> Exhibit 44, PSI's Response to the IIO's First RFI, Document 11, 20160208 Dexia KD Public sector CB - Inaugural Rating - Post cmt, p.1; Supervisory Report, Exhibit 56, II\_20160419\_Dexia Kommunalbank\_Post committee memo, p.1; and Supervisory Report, Exhibit 76, IV\_20160608\_Dexia Kommunalbank\_Monitoring committee\_Post committee memo, p.1. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 12, which indicates that the date of adoption of these bespoke tools is 8 February 2016.

<sup>114</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, pp. 3-6.

<sup>115</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, pp. 7-8.

<sup>116</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, p. 9.

<sup>117</sup> Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating, pp. 17-18.

<sup>118</sup> Supervisory Report, Exhibit 75, 20160704 Bankia Spanish MCB Press Release.

<sup>119</sup> Supervisory Report, Exhibit 39, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public Pre cmt, p. 1.

106. The rating reflected the support provided by the cover pool<sup>120</sup>. In this case, the analysis of the cover pool allowed to support a maximum credit differentiation of 9 notches<sup>121</sup>, which translated into a rating buffer of 1 notch<sup>122</sup>.
107. To analyse Bankia's Spanish mortgage covered bonds, the PSI applied in particular the 2015 CB Methodology and the principles as per its 2015 General Structured Finance Rating methodology for the asset and cash flow analysis<sup>123</sup>.
108. According to the rating report, the PSI "analysed the cover pool and its cash flows as of March 2016 and reviewed previous cover pool in order to understand its rating stability"<sup>124</sup>. More precisely, the analysis of the cover pool was done through several excel files to benchmark credit performance and recovery rates and a bespoke cash flow tool coded in python<sup>125</sup>. The PSI assessed the credit quality and distribution of the cover pool assets<sup>126</sup>. It also analysed the cash flow characteristics (including market risk exposure, asset liability mismatch risk and overcollateralisation)<sup>127</sup> and the counterparty risk<sup>128</sup>. Appendix II to the rating report on Bankia's Mortgage covered bonds also provides technical information on the PSI's covered bond credit risk and cash flow modelling used by the PSI<sup>129</sup>.

#### **Development and approval of the 2016 CB Methodology**

109. The Board considers the main steps which led to the development and approval, on 22 July 2016<sup>130</sup>, of an updated version of the PSI's CB Methodology (the "2016 CB Methodology").
110. On 24 May 2016, the IRF sent to the CB analytical team a list of topics to be considered for the review of the 2015 CB Methodology<sup>131</sup>.
111. One of the proposed topics related to the PSI's analytical approach for highly rated issuers<sup>132</sup>. The objective of this topic of discussion was to clarify whether a CB rating may be assigned solely on the basis of the fundamental approach (i.e. the analysis of the legal framework and resolution regime), bearing in mind that if there was no rating buffer, the

<sup>120</sup> Supervisory Report, Exhibit 75, 20160704 Bankia Spanish MCB Press Release, p.1.

<sup>121</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, p. 1.

<sup>122</sup> <sup>122</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, p.2 and Supervisory Report, Exhibit 75, 20160704 Bankia Spanish MCB Press Release, p.1.

<sup>123</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, p.14; Please see Exhibit 11, PSI's Response to the IIO's First RFI, Question 9, for an explanation of why other methodologies than the 2015 CB Methodology were indicated.

<sup>124</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, p.3.

<sup>125</sup> Supervisory Report, Exhibit 39, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public Pre cmt, p.1.

<sup>126</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, pp. 3-7.

<sup>127</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, pp. 7-9.

<sup>128</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, pp. 9-10.

<sup>129</sup> Supervisory Report, Exhibit 57, 20160704 Bankia Spanish MCB - CH Inaugural Rating - turn to public RC memo, pp. 23-27.

<sup>130</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final.

<sup>131</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 1; Supervisory Report, Exhibit 47, IRF Comments and areas for improvements on Covered Bond Rating Methodology 2016.

<sup>132</sup> Supervisory Report, Exhibit 47, IRF Comments and areas for improvements on Covered Bond Rating Methodology 2016.



PSI might have to withdraw the rating in case of a ICSR downgrade, or whether a “light” analysis of the cover pool with publicly available information was needed<sup>133</sup>. Another topic related to the cover pool quantitative approach for non-highly rated issuers<sup>134</sup>.

112. A discussion between the CB analytical team and the IRF took place on 6 June 2016<sup>135</sup>, followed by written exchanges<sup>136</sup>. In particular, concerning the clarification in the CB Methodology about “the type of cover pool analysis that can be done for unsolicited ratings, when the final rating is predominantly based on the fundamental support factors”<sup>137</sup>, the CB analytical team made the following proposals:
113. “Generally avoid rating covered bonds on an unsolicited basis – only provide such ratings when there is significant market interest as it is a) a new jurisdiction where covered bonds become newly established or where we want to showcase our criteria and b) where the highest covered bond rating in itself can already be achieved by the combination of a strong ICSR and the fundamental support factors<sup>138</sup>”.
114. “Provide in the criteria a conceptual approach for a “light” cover pool analysis that allows to identify whether the cover pool can provide additional benefit over and above the fundamental uplift (...)”<sup>139</sup>.
115. Further discussions took place in June 2016 between the IRF and analysts<sup>140</sup>.
116. On 29 June 2016, the lead analyst sent an updated draft of the 2016 CB Methodology<sup>141</sup>, which included “clarification on the quantitative part of the cover pool analysis. Either a) AAA rating is achieved via the fundamental analysis and thus cover pool analysis is done primarily for continuity and rating stability (Appendix IV Cover pool analysis for fundamental support-based ratings and b) a detailed cover pool analysis is needed as part of the CB rating (2.2 Cover pool analysis and Appendix II)”<sup>142</sup>.
117. Another round of interactions took place within the PSI at the end of June and beginning of July 2016 (including comments from the IRF on 30 June 2016<sup>143</sup>, and discussions between the IRF and the CB Analytical team on 1 and 5 July 2016<sup>144</sup>).

<sup>133</sup> Supervisory Report, Exhibit 47, IRF Comments and areas for improvements on Covered Bond Rating Methodology 2016.

<sup>134</sup> Supervisory Report, Exhibit 47, IRF Comments and areas for improvements on Covered Bond Rating Methodology 2016.

<sup>135</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p.1.

<sup>136</sup> See Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p.1; See in particular Supervisory Report, Exhibit 48, 2016 review\_answers CB analytical team.

<sup>137</sup> Supervisory Report, Exhibit 48, 2016 review\_answers CB analytical team, p.3.

<sup>138</sup> Supervisory Report, Exhibit 48, 2016 review\_answers CB analytical team, p.4.

<sup>139</sup> Supervisory Report, Exhibit 48, 2016 review\_answers CB analytical team, p.4.

<sup>140</sup> See Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, in particular pp. 1-2.

<sup>141</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 2

<sup>142</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 2.

<sup>143</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 2.

<sup>144</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 2.

118. On 6 July 2016, a methodology committee meeting (in which the IRF participated as voting participant<sup>145</sup>) took place<sup>146</sup>. Following this meeting, the comments from the IRF on the draft version of the 2016 CB Methodology “were removed from the document as after further discussion with review they either found their way into the methodology, were clarified or deemed not relevant<sup>147</sup>”.

119. According to the Methodology Committee Memorandum, “[t]his updated methodology primarily includes:

i) Clarifications in wordings and clearer structuring (e.g. numbering of paragraphs as well as a specific section on the importance of st liquidity),

ii) an expanded section on the expected loss and rating distance dependent stresses as well as an appendix on the technical details of the cover pool analysis. The appendix gives a more technical explanation of the asset credit risk analysis for public sector and mortgages (focus on default and recovery) as well as the cash flow modelling (focus on ir and fx risk, refin and reinvestment risk)

The underlying detailed rationales and further details can be found in the rating cmt papers for Dexia Kommunalbank Deutschland’s public sector covered bonds as well as Bankia S.A.’s mortgage covered bonds

iii) a clarification on the role of the cover pool analysis if the highest ratings are already supported by results of the fundamental framework analysis. Existing ratings are not impacted by this update.

iv) The removal of Appendix I (rating definitions) as available for all classes on [scoperatings.com](http://scoperatings.com)<sup>148</sup>”.

120. The Methodology Committee Memorandum states that the “cover pool analysis for fundamental support is new”<sup>149</sup>. It is however said that: “there is no immediate “threat” of any of the covered bonds with issuers that the rating needs to rely on the cover pool analysis<sup>150</sup>”.

<sup>145</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 3 and Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.2.

<sup>146</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 3.; and Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.2.

<sup>147</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.2.

<sup>148</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.3.

<sup>149</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.4.

<sup>150</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p. 4.

121. On 22 July 2016, the IRF gave her approval to the new version of the CB methodology<sup>151</sup> and the updated version of the CB methodology was published<sup>152</sup>.

122. ESMA was notified on 22 July 2016<sup>153</sup>. The PSI also reported to ESMA on the review of the 2015 CB Methodology in its bi-annual methodology report for the period going from 1 July 2016 until 31 December 2016<sup>154</sup>.

123. [redacted due to confidentiality]

124. [redacted due to confidentiality]

**Content of the 2016 CB Methodology regarding the analysis of the cover pool and other changes compared to the 2015 CB Methodology**

125. The Board notes that the main changes in the 2016 CB Methodology relate to the cover pool analysis.

126. The reference made in the 2015 CB Methodology to the necessity to perform a thorough analysis of the cover pool for all rated covered bonds was removed from the 2016 CB Methodology<sup>155</sup>.

127. Also, the 2016 CB Methodology added that “[t]he cover pool analysis is less important<sup>156</sup>” and “[f]or highly rated issuers active in countries where the fundamental support already allows the highest rating to be achieved, the cover pool analysis might only be needed to provide comfort on the covered bonds’ rating stability<sup>157</sup>”.

128. Moreover, the 2016 CB Methodology reorganised the section on the cover pool analysis and provided more insight into the different elements of the cover pool analysis than the 2015 CB Methodology, including a new annex consisting of a technical note on the covered bond risk analysis (Appendix II of the 2016 CB Methodology)<sup>158</sup>.

129. Finally, Appendix IV was added to the 2016 CB Methodology<sup>159</sup>. Appendix IV explains the simplified cover pool analysis carried out by the PSI in those cases where based on the legal framework and the resolution regime, a AAA rating can already be achieved and / or where insufficient information on the covered bond structure is available. According to

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<sup>151</sup> Supervisory Report, Exhibit 49, I\_2016 cb methodology update - Approval by Annick (Review function).

<sup>152</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final.

<sup>153</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published.

<sup>154</sup> Exhibit 46, PSI's Comments on the Supervisory Report, Document 3, Annex 12.1 - Methodology Report, pp.3-4.

<sup>155</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), pp .3 and 9.

<sup>156</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), p.3.

<sup>157</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), p.3.

<sup>158</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), pp. 9-16 and pp. 22-26.

<sup>159</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), pp. 28-30.



this appendix, “[the PSI’s] methodology generally will constrain the cover pool benefit arising from a simplified analysis by up to one notch on top of the fundamental support<sup>160</sup>”.

130. Apart from the changes regarding the cover pool analysis, the 2016 CB Methodology introduced other changes as well. In particular, the 2016 CB Methodology included further details on the fundamental support analysis<sup>161</sup> and the legal framework analysis<sup>162</sup> carried out by the PSI.

### **The Board has considered the following applicable legal provisions:**

131. References to the Regulation in this Statement of Findings refer to the text of the Regulation (EC) No 1060/2009 (as amended where relevant) in force at all material times in relation to the matters which are the subject of this case.
132. In this respect, the following should be noted.
133. Besides the provisions of the (initial) Regulation, which entered into force in December 2009, account must consequently be taken of the amendments to the Regulation introduced through Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies<sup>163</sup> (“CRA II Regulation”), which entered into force on 1 June 2011.
134. Further amendments to the Regulation were also introduced through Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 as well as through Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013<sup>164</sup> amending Regulation (EC) No 1060/2009 on credit rating agencies (“CRA III Regulation”). The amendments introduced by the CRA III Regulation entered into force on 20 June 2013.
135. Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014<sup>165</sup> also introduced limited changes to the Regulation.

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<sup>160</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), p.28.

<sup>161</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), p.5.

<sup>162</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), pp. 5-9.

<sup>163</sup> Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011, p.30.

<sup>164</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, OJ L 146, 31.5.2013, p.1.

<sup>165</sup> Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority), OJ L 153, 22.2.14, p.1.

### **Relevant legal provisions regarding the use of methodologies that are systematic**

136. Article 8(3) of the Regulation provides that “a credit rating agency shall use rating methodologies that are (...) systematic (...)”.
137. Recital 23 of the Regulation states that “Credit rating agencies should use rating methodologies that are rigorous, systematic, continuous (...)” and that “[s]uch a requirement should not, however, provide grounds for interference with the content of credit ratings and methodologies by the competent authorities and the Member States (...). Those requirements should not be applied in such a way as to prevent new credit rating agencies from entering the market”.
138. In addition, Recital 27 of the CRA III Regulation states that “[a]lthough Regulation (EC) No 1060/2009 confers on ESMA the power to verify that methodologies used by credit rating agencies are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing, that verification process should not grant ESMA any power to judge the appropriateness of the proposed methodology or of the credit ratings issued following the application of the methodologies”.
139. Article 23 of the Regulation also provides that “[i]n carrying out their duties under this Regulation, ESMA, the Commission or any public authorities of a Member State shall not interfere with the content of credit ratings or methodologies”.
140. Point 43 of Section I of Annex III (as amended by the CRA II Regulation) provides that: “[t]he credit rating agency infringes Article 8(3) by not using rating methodologies that are rigorous, systematic (...)”.
141. According to Article 2 of the Commission Delegated Regulation (EU) No 447/2012<sup>166</sup> (the “Delegated Regulation”), which entered into force on 19 June 2012, “a credit rating agency shall at all times be able to demonstrate to ESMA its compliance with the requirements set out in Article 8(3) of Regulation (EC) No. 1060/2009 relating to the use of credit rating methodologies”.
142. In relation to the obligation to use systematic methodologies, Article 5 (1) of the Delegated Regulation describes how to assess that a methodology is systematic:
- “A credit rating agency shall use a credit rating methodology and its associated analytical models, key credit rating assumptions and criteria that are applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it”.

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<sup>166</sup> Commission Delegated Regulation (EU) No 447/2012 of 21 March 2012, supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies, OJ L 140, 30.05.2012, p. 14 (the “Delegated Regulation”).

## **Relevant legal provisions regarding material changes to methodologies**

### *Obligation to publish and call for comments regarding intended material changes to methodologies*

143. Under Article 8(5a) of the Regulation (as amended by the CRA III Regulation), “[a] credit rating agency that intends to make a material change to, or use, new rating methodologies, models or key rating assumptions which could have an impact on a credit rating shall publish the proposed material changes or proposed new rating methodologies on its website inviting stakeholders to submit comments for a period of one month together with a detailed explanation of the reasons for and the implications of the proposed material changes or proposed new rating methodologies”.
144. Point 3b of Section II of Annex III of the Regulation (as amended by the CRA III Regulation) provides that “the credit rating agency infringes the first subparagraph of Article 8(5a) by not publishing on its website the proposed new rating methodologies or the proposed material changes to the rating methodologies that could have an impact on a credit rating together with an explanation of the reasons for and the implications of the changes”.
145. In addition, Recital 27 of the CRA III Regulation stated that “[i]t is important to ensure that modifications to the rating methodologies do not result in less rigorous methodologies. For that purpose, issuers, investors and other interested parties should have the opportunity to comment on any intended change to rating methodologies. This will help them to understand the reasons behind new methodologies and for the change in question. Comments provided by issuers and investors on the draft methodologies may provide valuable input for the credit rating agencies in defining the methodologies. ESMA should also be notified of intended changes”.
146. ESMA’s Guidelines and Recommendations on periodic information to be submitted to ESMA by Credit Rating Agencies (the “Guidelines on Periodic Reporting”)<sup>167</sup> set out the information that should be submitted by CRAs to enable ESMA’s ongoing supervision of CRAs on a consistent basis. These Guidelines became effective on 23 August 2015<sup>168</sup> and replaced<sup>169</sup> the Guidance on the enforcement practices and activities to be conducted under Article 21.3(a) of the Regulation<sup>170</sup> adopted by ESMA’s predecessor (Committee of European Securities Regulators, “CESR”) in August 2010.
147. Section 5.12 of the Guidelines on Periodic Reporting clarifies ESMA’s expectations regarding CRAs’ obligations related to notifications of material changes to the initial conditions for registration. In this respect, it states that ESMA considers a material change

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<sup>167</sup> Exhibit 61, ESMA/2015/609, Guidelines on periodic information to be submitted to ESMA by Credit Rating Agencies, 23 June 2015 (“Guidelines on Periodic Reporting”).

<sup>168</sup> Exhibit 62, Overview of ESMA’s Guidelines (last updated 16 April 2019), p.1.

<sup>169</sup> Exhibit 63, Final Report on the Guidelines on periodic information to be submitted to ESMA by Credit Rating Agencies, 19 March 2015, p.4.

<sup>170</sup> Exhibit 64, CESR/10-944, CESR’s Guidance on enforcement practices and activities to be conducted under Article 21.3(a) of the Regulation, 30 August 2010.

to the initial conditions for registration to be “a change in the information submitted in the registration application and, more generally, any change that may affect compliance with the requirements of the CRA Regulation” and that “CRA should notify ESMA of any material changes to the conditions of its initial registration, including but not limited to the following matters: (...) (n) Rating methodologies, models or key rating assumptions (...)”<sup>171</sup>.

148. In addition, Question 7 of ESMA’s “Questions and Answers on Implementation of the Regulation (EU) No 462/2013 on Credit Rating Agencies” (the “Q&A”) <sup>172</sup> refers to situations in which a change to methodologies has to be considered as a material change for the purposes of Article 8(5a) and 14(3) of the Regulation:

“CRAs that intend to make a material change to methodologies, models, or key rating assumptions which could have an impact on a credit rating need to disclose the reasons for such changes. Material changes to methodologies, models, or key rating assumptions might include among others:

- i) a change in the key criteria used;
- ii) a change in the key rating assumptions and key variables used in the rating methodology;
- iii) a change in the respective weight of the qualitative and quantitative factors;
- iv) a change in the way driving factors are assessed; or
- v) a change that has a direct or indirect impact on a significant number of credit ratings.

CRAs should explain in a comprehensive manner which of the above-mentioned elements has significantly contributed to a change to methodologies, models or key rating assumptions. The elements which have been changed should also be clearly disclosed”.

#### *Obligation to notify ESMA about material changes to the methodologies*

149. According to the third subparagraph of Article 14(3) of the Regulation (as amended by the CRA III Regulation), “(...) the credit rating agency shall notify ESMA of the intended material changes to the rating methodologies, models or key rating assumptions or the proposed new rating methodologies, models or key rating assumptions when the credit rating agency publishes the proposed changes or proposed new rating methodologies on its website in accordance with Article 8(5a). After the expiry of the consultation period, the credit rating agency shall notify ESMA of any changes due to the consultation”.

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<sup>171</sup> Exhibit 61, Guidelines on Periodic Reporting, pp.8-9.

<sup>172</sup> Exhibit 65, ESMA/2013/1935, Questions and Answers on Implementation of the Regulation (EU) No 462/2013 on Credit Rating Agencies (the “Q&A”), 17 December 2013, pp.9-10.

150. Point 3a of Section II of Annex III of the Regulation (as amended by the CRA III Regulation) provides that “the credit rating agency infringes Article 14(3) by not notifying ESMA of the intended material changes to the existing rating methodologies, models or key rating assumptions or of the proposed new rating methodologies, models or key rating assumptions when it publishes the rating methodologies on its website in accordance with Article 8(5a)”.

151. In addition, Recital 37 of the Regulation states that: “(...) With a view to ensuring transparency, disclosure of any material modification to the methodologies and practices, procedures and processes of credit rating agencies should be made prior to their coming into effect, unless extreme market conditions require an immediate change in the credit rating”.

***Other obligations regarding material changes to the methodologies***

152. According to Article 8(6) of the Regulation (as amended by the CRA III Regulation), “[w]here rating methodologies, models or key rating assumptions used in credit rating activities are changed in accordance with Article 14(3), a credit rating agency shall: [...];

(aa) immediately inform ESMA and publish on its website the results of the consultation and the new rating methodologies together with a detailed explanation thereof and their date of application;

(ab) immediately publish on its website the responses to the consultation referred to in paragraph 5a except in cases where confidentiality is requested by the respondent to the consultation; (...)”.

153. Regarding the infringement, Point 4a of Section III of Annex III of the Regulation (as amended by the CRA III Regulation) provides that “the credit rating agency infringes point (aa) of Article 8(6), where it intends to use new rating methodologies, by not informing ESMA or by not publishing immediately on its website the results of the consultation and those new rating methodologies together with a detailed explanation thereof and their date of application”. The Board notes that the Regulation does not include a specific provision that would lay down the infringement corresponding to a breach of the requirement of point (ab) of Article 8(6) of the Regulation.

**Having considered the IIO's Statement of Findings, the material in the complete file and the PSI's written submissions, the Board sets out below its findings.**

**Findings of the Board with regard to the infringement at Point 43 of Section I of Annex III of the Regulation concerning the use of systematic methodologies**

154. This section of the Statement of Findings analyses whether the PSI breached the following requirement regarding its CB Methodology:

"A credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing" (Article 8(3) of the Regulation).

155. If this requirement is not met, this would constitute the infringement set out at Point 43 of Section I of Annex III of the Regulation.

**Board's Assessment of the systematic use of the 2015 CB Methodology for the purposes of Article 8(3) of the Regulation and Article 5(1) of the Delegated Regulation**

156. It results from Article 8(3) of the CRA Regulation and Article 5(1) of the Delegated Regulation that a credit rating methodology must be applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it.

*Board's General considerations about the systematic use of methodologies*

157. The Board acknowledges that the usual meaning of the term "systematic", according to the Oxford University Press' Oxford Dictionaries and the Collins Dictionary of English<sup>173</sup>, refers to "done or acting according to a fixed plan or system; methodical" and to "something that is done in a systematic way is done according to a fixed plan, in a thorough and efficient way".

158. In addition, the Board, in its initial Statement of Findings, already noted that Article 5(1) of the Delegated Regulation, which complements Art. 8(3) of the CRA Regulation, clearly refers to "all" credit ratings in "a given asset class or market segment". On this last point, the Board notes that ESMA's Supervision Department, in its Supervisory Report, explained that the CB ratings issued in 2015 and 2016 under the 2015 CB Methodology "(...) relate

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<sup>173</sup> See Exhibit 66, Definition of "systematic", Oxford Dictionaries, and Exhibit 67, Definition of "systematic", Collins English Dictionary.



to two types of CBs, i.e. mortgage and public sector debt, whereas the asset class is the same, namely the CB asset class<sup>174</sup>". The Board also acknowledges that the PSI did not challenge this point in its Comments on the Supervisory Report<sup>175</sup>.

159. Furthermore, the Board noted that in its Response to the IIO's initial Statement of Findings, the PSI argued that "(...) Article 8(3) of the Regulation and Article 5 of the Delegated Regulation stipulate requirements with regard to the content of the rating methodology used by the CRA. They do not regulate any deficiencies in the day-to-day application of the rating methodology<sup>176</sup>". According to the PSI, "(...) it is overlooked in the SoF that there is a difference between not systematically using (in the meaning of "applying") a rating methodology and not using a systematic methodology. (...) only the latter can be subject to a fine according to Article 36a(2) of the Regulation (...) <sup>177</sup>".

160. On this point, the Board, in the initial Statement of Findings, already agreed with the IIO and rejected the PSI's argumentation. In fact, this argumentation is clearly against the text of Article 5(1) of the Delegated Regulation, which complements Article 8(3) of the CRA Regulation and specifies that, when assessing that a credit rating methodology is systematic, ESMA shall look at whether a CRA is using "a credit rating methodology and its associated analytical models, key credit rating assumptions and criteria that are applied systematically in the formulation of all credit ratings in a given asset class or market segment" [emphasis added]. The Delegated Regulation explicitly links together the use and the application of the methodology to assess whether it is systematic. According to the Oxford University Press' Oxford Dictionaries and the Collins Dictionary of English, the verb "apply" implies making use of something<sup>178</sup>, in this case making use of a credit rating methodology and not only defining this methodology. It is thus clear from Article 5(1) of the Delegated Regulation that for a CRA to comply with its obligation under Article 8(3) of the Regulation, a methodology needs to be applied systematically in the formulation of all credit ratings, unless the CRA has an objective reason to diverge. The fact that a methodology would be defined / designed in a systematic way would not be sufficient for the purposes of the Regulation if it is not used / applied in a systematic way. In the absence of an objective reason for divergence, the unsystematic application / use of a (systematically defined) methodology constitutes an infringement of the Regulation, which is liable to a fine, in accordance with Article 36a(2)(a) of the Regulation.

161. The Board acknowledges that the PSI reiterated the main arguments above in the context of partially new arguments developed in the written submissions to the Board. The

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<sup>174</sup> Exhibit 1, Supervisory Report, Paragraph 262.

<sup>175</sup> Exhibit 8, PSI's Comments on the Supervisory Report. In addition, the IIO notes that the PSI itself refers to the asset class of covered bonds: see Exhibit 8, PSI's Comments on the Supervisory Report, p.3 where the PSI indicated that "Bespoke tools would, in our view, not qualify as a model as long as it would not rise to the level of a generic software implementation that was suitable for a broader range of CB ratings or for the asset class of CB's as a whole" (emphasis added).

<sup>176</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 24.

<sup>177</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 25.

<sup>178</sup> See Exhibit 217, Definition of "apply", Oxford Dictionaries and Exhibit 218, Definition of "apply", Collins English Dictionary. In particular, the Collins Dictionary of English clarifies that "if you apply something such as a rule, system, or skill, you use it in a situation or activity".

Board confirms its initial findings and rejects the arguments, on the basis of the following analysis of the PSI's written submissions.

*First issue: can ESMA sanction the non-systematic application of a rating methodology?*

162. The PSI argues that Article 8(3) of CRA Regulation would not cover the application phase of the methodology. The PSI makes a distinction between the concept (i.e. the design) of the methodology and its application and conducts the analysis of the relevant legal provisions, in order to prove that ESMA can only sanction the lack of a systematic methodology in terms of concept/design, and not also the lack of systematic application of a (in theory systematic) methodology, as in the case at stake.

163. To establish this distinction, the PSI - as supported by an academic opinion - makes use of different arguments, which are analysed one by one by the Board:

The wording of Article 8(3).

164. The wording of 8(3) – as well as the corresponding infringement provision - would be exclusively focussed, in the view of the PSI, on the characteristics of the design of the methodology and would not cover the application of the methodology. In the provision, in particular, there is no mention of the word 'application'.

165. In the PSI's view, being the provision of Article 8(3) exclusively focussed on the concept of the methodology, it could not cover also the application phase. ESMA, on this basis, could not sanction an error in the application of the methodology.

Board's analysis

166. The Board considers that the simple reading of the text of Article 8(3) of the CRA Regulation is clear: "A credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing." (emphasis added). The provision clearly points to the application of the rating methodologies and not only to how they have to be construed.

167. Equally, the corresponding infringement provision (No 43 of Annex III Section I of the Regulation) states that "a credit rating agency infringes Article 8(3) by not using rating methodologies that are (...) systematic (...)" (emphasis added).

168. This reading is also accepted by the Academic in the legal opinion. The Professor considers that "On the other hand, the provision contains the term 'use'. This in turn may lead to the conclusion that the application of a rating methodology (the concept of which fulfils the requirements of Article 8(3) of the CRA Regulation) must meet the requirements of Article 8(3)"<sup>179</sup>.

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<sup>179</sup> See written submissions to the Board, academic opinion, p. 60.



169. Indeed, the Board considers that assessing compliance of the concept/design of a methodology alone, without assessing whether this methodology is effectively used or not is vain. Theory and practice of the rating methodology cannot be dissociated without deviating from the rationale of the CRA Regulation: the methodology is nothing but the description of what the CRA is expected to do in practice. It is therefore difficult -if not impossible- to imagine how a methodology that has to be systematic could be applied correctly without its application itself being systematic, nor why should the methodology be validated in the first place if the CRA could subsequently pick and choose which parts to apply and which others to ignore.
170. The Academic himself<sup>180</sup> refers to the definition of 'systematic', included in the provision of Article 8(3) of CRA Regulation, as meaning "that a concept is followed consistently and is implemented as planned (...) Hence when assessing whether a rating method is systematic, the method should-according to the legislator- be applied uniformly to all the ratings within a certain class". He therefore acknowledges the fundamental interrelation between the concept and its implementation/ application. Moreover, in the analysis of the term 'continuous' also included in 8 (3) of the CRA Regulation<sup>181</sup>, the Academic states "The purpose of that requirement that the rating methodology must be "continuous" is that the methodology must be applied consistently and unaltered to all ratings.
171. In fact, the Academic concludes in favour of a narrow reading of the provision of Article 8(3) only on the basis of an alleged 'danger of circularity'<sup>182</sup>: "If a rating methodology would only be classified as systematic within the meaning of Article 8(3) of the CRA Regulation (...), if it were also systematically applied, this would mean that a rating methodology could never be classified as systematic when it was developed".
172. The above interpretation is certainly an interesting intellectual creation, however in the case at hand there can be no doubt that the methodology was considered systematic both by the PSI and ESMA.
173. All in all, it is clear that Article 8(3) of the CRA Regulation imposes requirements on the use of CRA methodologies and that this use cannot go against the principles set out in the approved methodology.
174. On the basis of the above analysis, the Board dismisses the objections raised in this respect.

*ESMA's alleged extension of scope of the CRAR through the Delegated regulation.*

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<sup>180</sup> See written submissions to the Board, academic opinion, p. 52.

<sup>181</sup> See written submissions to the Board, academic opinion, p. 55.

<sup>182</sup> See written submissions to the Board, academic opinion, p. 63.

175. In the view of the PSI, ESMA could not use the provision of Article 5(1) of the Delegated Regulation, that focusses on the application of the methodology, in order to expand the scope of Article 8(3) and punish incorrect behaviours in the application phase.

Board's analysis

176. The Board considers essential to clarify the relation between Article 8(3) of the CRA Regulation and Article 5(1) of the Delegated Regulation No 447/2012. In fact, the Board bases its interpretation on the clear provision of the CRA Regulation, as complemented by the relevant provision of the Delegated Regulation.
177. The rationale behind the provisions of Delegated Regulation No 447/2012, as clarified in recital 2, is to ensure transparency in the assessment carried out by ESMA. Article 5 of the Delegated Regulation, entitled 'Assessing that a credit rating methodology is systematic', clarifies, for transparency towards the CRAs, that "the credit rating agency shall use a credit rating methodology and its associated analytical models, key credit rating assumptions and criteria that are applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from it". The provisions do not leave room to doubt. In any case, even from the literal combination of the two provisions (Article 8(3) CRA Regulation and 5(1) Delegated Regulation), it is easy to infer, thanks to the same beginning ("a credit rating agency shall use a rating methodology") that a systematic methodology is a methodology which is applied systematically.

*Comparison with the correction procedure of Article 8(7) of CRA Regulation*

178. In the view of the PSI, the intention of the legislator to distinguish between the concept of the methodology and its application would be proved by the existence of Article 8(7) of the CRA Regulation, which provides a correction procedure in case the CRA realises the existence of any mistake in the (concept of the) methodology or in its application.
179. Article 8(7) imposes a number of obligations on a CRA in case of errors and states "Where a credit rating agency becomes aware of errors in its rating methodologies or in their application it shall immediately...". The existence of this provision, that would cover also the 'application' phase of the methodology, would prove that Article 8(3) must be a *contrario* interpreted strictly (in the sense that it can only be infringed if a CRA designs and applies a rating methodology that in its design is not systematic).

Board's analysis

180. The argument of the PSI is weak and does not prove that Article 8(3) should cover only the design of the methodology.
181. In particular, in the PSI's view, the concept/design of the methodology would be covered by both provisions of Article 8(3) and, for the case of errors, Article 8(7), while its application would be covered only by the provision of Article 8(7).

182. As a result, no provision would capture the errors in the application of the methodologies that are not notified to ESMA. This already shows the illogic nature of the reasoning. However, for the sake of completeness, further considerations are provided below.

183. It is the Board's view that the two provisions serve different purposes. Article 8(3) is about the obligation of the CRAs to use methodologies with certain characteristics, while Article 8(7) is about the notification obligation of the CRAs in case they become aware of errors. This is also manifested by the fact that the corresponding infringement provisions are in different sections of the Regulation. More specifically, the infringement provision for Article 8(3) is in section I of Annex III, entitled "Infringements related to conflicts of interest, organisational or operational requirements", though the infringement provision for Article 8(7) is under section II of Annex III entitled "Infringements related to obstacles to the supervisory activities".

184. It is therefore clear that the use/application of the rating methodology is covered by the provision of Article 8(3) of CRA Regulation. The basic assumption of the PSI is therefore discarded.

*On the alleged violation of the principles of legal certainty and legality.*

185. The Board acknowledges that the PSI claims that even if its interpretation is not to be followed, it should at least be accepted that both provisions of Article 8(3) of the CRA Regulation and of Article 5(1) of the Delegated Regulation are not clear, as there is an alternative reading (the PSI's reading).

186. The Board's reading of Article 8(3) is considered by the PSI as 'extensive', to cover the non-systematic application. On this point the PSI states: "The view of the BoS regarding the requirements of a systematic rating methodology according to Article 8(3) of the Regulation is to say the very least far from obvious"<sup>183</sup>.

187. This is in line with the PSI's view in relation to Article 5(1) of the Delegated Regulation, for which the PSI concludes that "the provision in Article 5(1) of the Delegated Regulation No 447/2012 which is cited by ESMA does not lead to unambiguous result either. (...) It only stipulates that the rating methodology applied must be systematically used (...)"<sup>184</sup>.

188. On the basis of the above, the PSI concludes that by sanctioning the non-systematic application of the 2015 CB methodology, ESMA would violate the principle of legality (*nulla poena sine lege*) and of legal certainty.

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<sup>183</sup> See written submissions to the Board, p. 23.

<sup>184</sup> See written submissions to the Board, academic opinion, p. 63.

#### Board's analysis

189. With specific regard to the principle of legal certainty, the Board notes that it is quite common for a PSI to claim the lack of a clear provision and therefore to invoke this principle, which requires that EU rules enable those concerned to know precisely the extent of the obligations which are imposed on them. This, especially in case of negative financial consequences.
190. It is not enough for the PSI to invoke an alternative interpretation and to claim that the rules are unclear to establish the violation of the principle of legal certainty, as the Board of Supervisors and the Board of Appeal have previously confirmed<sup>185</sup>.

*Second issue: should ESMA issue any fine for the infringement by the PSI of the correction procedure established in Art. 8(7) – instead of using Art. 8(3)?*

191. In connection to the first issue, in order to contradict the application by ESMA of Art.8(3) of the Regulation, the PSI seems to suggest the application to the specific case of the correction procedure set in Art. 8(7), that might lead to different infringement<sup>186</sup>, which is in fact established in point 49a Annex III Section I of the Regulation.
192. The Board notes that in this case the PSI uses Article 8(7) not as an interpretation tool but as a real alternative.
193. The PSI refers indeed to the legal opinion, where it is stated<sup>187</sup> that in the present case “doubts exist at most with regard to the correct application of the methodology (...). In this case (...) the procedure pursuant to Art. 8(7) of the CRA Regulation applies”. On this basis, they argue that “Art. 8(7) of the Regulation (...) sets out a clear way to proceed if any CRA applies its rating methodology erroneously, as this may be accompanied by other sanctions”. In that respect the PSI claims that a two-steps approach should be followed: First a CRA should be granted the opportunity to correct its methodology in accordance with Article 8(7) of the CRA Regulation and then, if the CRA deliberately or negligently fails to detect or report an erroneous methodology or its erroneous application, it commits a violation of 8(3) that results in the sanctions for the violation of this provision.

#### Board's analysis

194. First, the Board notes that this argument is contradictory to the argument presented below (paras. 279-302), on the justified deviation from the methodology. It is also relevant to note that the legal opinion explicitly (and the PSI implicitly) recognises that the CB rating issuances of September and November 2015 have been conducted in breach of the

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<sup>185</sup> The Joint BoA has rejected the argument in the Nordic Banks cases, stating that “the fact that a given provision of financial regulation is open to different interpretations does not necessarily invoke the principle of legal certainty in respect of sanctions”. See Decisions of the Joint Board of Appeal in the Appeals of Svenka Handelsbanken AB, Skandinaviska Enskilda Banken AB, Swedbank AB and Nordea Bank Abp against ESMA’s decision in the Nordic Banks case (ref. BoA D 2019 01, BoA D 2019 02, BoA D 2019 03 and BoA D 2019 01).

<sup>186</sup> See written submissions to the Board, pp. 6 and 18.

<sup>187</sup> See written submissions to the Board, academic opinion, p. 43.

commitment, included in the 2015 methodology, to perform the CP analysis. Moreover, in this structure, the PSI accepts that at the second step the sanction would also cover the application of the methodology (and not only its adoption).

195. Then, the Board considers relevant that the CRA Regulation does not establish any hierarchy nor chronological sequence amongst the infringements. Moreover, as analysed above in the considerations regarding the First Issue, Art.8(3) and Art.8(7) serve different purposes. In the present case, the only applicable requirement regarding sanctions is laid down in Article 36a(4), according to which, “Where an act or omission of a credit rating agency constitutes more than one infringement listed in Annex III, only the higher fine calculated in accordance with paragraphs 2 and 3 and related to one of those infringements shall apply.”
196. Therefore, in the case at stake, should the Board establish (also) the infringement of Art. 8(7), this would not exclude the already established infringement of Art. 8(3). Simply, the higher fine would be applied.
197. In any case, the application of Art. 8(7) of the Regulation in the case at stake is contradicted by the facts and the evidence gathered. The PSI never admitted having committed an error in the application of the methodology and never notified ESMA about the commission of such error. On the contrary, the PSI claimed to have behaved correctly, for various reasons (including that the CP analysis was not necessarily required by the methodology in its view).
198. On the basis of the above analysis, the Board finds that also this issue must be discarded.
199. Moreover, the Board acknowledges that, in its Response to the IIO’s initial Statement of Findings, although the PSI agreed that “systematic” should be understood as acting according to a fixed plan or system, it also argued that it “(...) does not imply that such plan is accurately described within its representation to the public<sup>188</sup>”. According to the PSI, in order to assess whether a rating method has been applied systematically, the understanding of the credit rating agency’s employees, who deal with the rating methodology in their day-to-day business, is decisive (...) <sup>189</sup>. The PSI also stated that “According to the understanding of the persons involved in CB rating, a cover pool assessment for the actual rating was only to be carried out if the issuer’s rating on its own, or after application of the first building block, did not achieve the top rating of AAA<sup>190</sup>” and “This understanding of the method was applied consistently and systematically (i.e. without exception) in the period in question (...) <sup>191</sup>”. The PSI even goes as far as to say that “(...) this may justify the accusation of an incorrect publication of an actually systematic

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<sup>188</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 32.

<sup>189</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 33.

<sup>190</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 34.

<sup>191</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 35.

methodology<sup>192</sup>” rather than an infringement linked to the non-systematic use of the methodology.

200. The Board strongly rejects this argumentation of the PSI, because the subjective interpretation of the methodology cannot be considered by ESMA in the assessment of the systematic application of the methodology, even if the employees’ understanding was applied without exceptions (i.e. in all the cases of highly rated issuers).

201. On the same point, the Board also agrees with the IIO in considering that the PSI approved its 2015 CB Methodology in June 2015 and published it in July 2015. This is the text that must have guided PSI’s analysts in formulating the ratings. It is the one to be taken into consideration to assess whether the PSI has a systematic methodology for the purposes of the Regulation. Whether an approved and published rating methodology has been applied systematically in the formulation of all ratings in a given asset class or market segment should obviously be assessed in light of its content and not on the basis of an alleged different understanding of this methodology by the CRA staff.

202. Finally, the Board already considered in its initial Statement of Findings the following PSI’s submission in the context of its Response to the IIO’s initial Statement of Findings: “The credit rating has to be distinguished from the notion of a “rating outlook” (...) Whereas Article 8(3) of the Regulation prescribes the use of systematic ratings methodologies, it does not require the use of a systematic “rating outlook methodology”. Otherwise, this would have been explicitly stated in the wording of Article 8(3) of the Regulation<sup>193</sup>”.

203. The Board agreed with the IIO and rejected this argument of the PSI. The PSI created a distinction that does not exist in the Regulation, in order to escape from its obligations regarding its methodologies. In this regard, there is nowhere in the Regulation a distinction between “credit rating methodologies” as opposed to “rating outlook methodologies”. On the contrary, for example, Article 8(2) of the Regulation, according to which “A credit rating agency shall (...) ensure that the credit ratings and the rating outlooks it issues are based on a thorough analysis of all the information that is available to it and that is relevant to its analysis according to the applicable rating methodologies” makes it clear that rating methodologies cover both credit ratings and ratings outlooks.

204. The Board acknowledges that the PSI reiterated the arguments above in the context of a partially new argument developed in the written submissions to the Board. The Board’s complete analysis of the partially new argument regarding the rating outlook included in the written submissions is developed below.

*Is the CP analysis to be considered as part of the rating outlook and therefore out of the scope of Art. 8(3)?*

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<sup>192</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 35.

<sup>193</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 36.



205. The PSI reiterates the defensive argument in the following terms<sup>194</sup>: “If the highest possible rating is achieved by the first building block (...) from an objective point of view the cover pool analysis can only serve as rating outlook (...)”. The basis of this statement is that the Academic “agrees that this differentiation is possible”.
206. In fact, the Academic, in the opinion<sup>195</sup>, stated that “it is not fundamentally impossible to classify a cover pool analysis, that has been carried out but is not relevant to the rating as such, as part of the rating outlook.” And further adds: “However, Scope has not explicitly identified the cover pool analysis as part of the rating outlook in its rating methodology of 2015. (...) the protective purpose of the CRA Regulation suggests that a rating outlook must be identified as such.
207. The above extracts of the legal opinions demonstrate that the basic assumption for this defensive argument (i.e. that the academic opinion “agrees that this differentiation is possible”) is at least misleading, if not completely wrong. First, there is a striking wording difference between ‘possible’ and ‘not fundamentally impossible’. Then, in practical terms, what is possible to infer from the opinion is, at maximum, that the PSI, in order to exclude the cover pool analysis from the rating methodology, should have clearly labelled the cover pool analysis as part of the rating outlook.
208. This is not the case, because the PSI included it in the methodology, as clarified also by the legal opinion. The argument can therefore be discarded.
209. On this basis the Board, having thoroughly analysed the written submissions of the PSI, confirms its initial findings and strongly rejects the PSI’s arguments.
210. The Board turns to the qualification of the facts and to the assessment of whether the 2015 CB Methodology, in particular regarding the assessment of the cover pool, was applied systematically in the formulation of all relevant CB credit ratings.

#### Board’s analysis of the content of the 2015 CB Methodology

211. In its initial Statement of Findings, the Board notes that there are numerous statements in the 2015 CB Methodology that indicate that, for all ratings, the analysis of the cover pool is an element included in the CB Methodology approved by the PSI. For example, and without being exhaustive, the Board considers the following statements, which refer to the analysis of the cover pool:
- “Scope therefore performs a thorough analysis of the cover pool because it provides key information about the robustness of the covered bond’s second recourse and, ultimately, the magnitude of the expected loss for the instrument<sup>196</sup>”.

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<sup>194</sup> See written submissions to the Board, p. 22.

<sup>195</sup> See written submissions to the Board, academic opinion, pp 73-75.

<sup>196</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.4.

- “Scope believes that the cover pool can generally further enhance the credit risk of the instrument by up to three notches above the uplift already provided by the fundamental status of covered bonds and the regulatory framework of the issuer<sup>197</sup>”.
- “This is why Scope performs an independent analysis of the cover pool<sup>198</sup>”.
- “Scope performs and publishes a detailed quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers. This is because the cover pool analysis helps to understand the likely stability of the covered bond rating, the efforts issuers must make to manage risks prudently, or the levels of overcollateralisation they have to provide to mitigate these risks. In addition to an assessment of the pool’s current risk exposure, our analysis aims to provide guidance on the drivers for potential rating migration<sup>199</sup>”.
- In the 2015 CB Methodology, there is a specific section on “Cover pool analysis”, which clearly indicates that “a thorough analysis of the cover pool needs to be performed for all rated covered bonds. The findings inform us on how specific features of the covered bond structure, as well as other country-specific aspects, may affect the probability of default and the loss given default. It also provides information on the likely rating sensitivity resulting from it<sup>200</sup>”.
- There is also a specific appendix dedicated to the “credit differentiation supported by the cover pool assessment”. It explains in particular the reasons and the number of notches that a cover pool analysis can bring as an uplift supporting a credit differentiation to the ICSR<sup>201</sup>.
- “A change in an issuer’s ICSR or a placement of its ICSR ‘under review’ will likely prompt a corresponding review of its covered bond ratings – unless the cover pool provides a sufficient buffer for a potential downgrade<sup>202</sup>”.

212. In the assessment of the content of the 2015, the Board thoroughly considers the points raised by the PSI.

213. The PSI indicated that “We recognize that some of the statements contained in the 2015 CB methodology were pointing to an analysis of the cover pool<sup>203</sup>”. Moreover, in May 2016, following a discussion with ESMA, the PSI discussed internally how it had responded to ESMA’s questions. With respect to the inconsistency in the wording of the methodology

<sup>197</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.4.

<sup>198</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.

<sup>199</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.

<sup>200</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.9.

<sup>201</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, Appendix II, p.17.

<sup>202</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.16.

<sup>203</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.1.



regarding the cover pool analysis, the PSI indicated that “We acknowledged that this must be a drafting oversight<sup>204</sup>”.

214. On this topic, the PSI also referred to other statements in the 2015 CB Methodology which, according to the PSI, point out that “(...) the analysis first focuses on the fundamental uplift available and that the CP structure would be regarded as a component that could provide additional uplift, which is logically only relevant where the highest achievable rating is not yet achieved<sup>205</sup>”. The PSI added that “(...) the cover pool can be disregarded as analytically not material where the primary rating driver is already strong enough to support a AAA rating since no further uplift would logically have been feasible<sup>206</sup>”.

215. In particular, the PSI emphasised that there were a number of statements in the 2015 CB Methodology implying that the cover pool analysis was not a rating driver for highly rated issuers<sup>207</sup>. For example, it referred to the following statements:

- “the supportive benefit of the cover pool only becomes relevant when the credit quality, and thus the bank ratings, start to migrate downwards<sup>208</sup>”;
- for highly rated banks, the PSI’s ratings “are driven primarily by the fundamental benefits of the regulatory framework applicable to banks and their covered bonds<sup>209</sup>”.

216. In assessing the argument, the Board considers relevant the indication of ESMA’s Supervision Department that it “(...) agrees that the 2015 CB methodology contains certain wording pointing to the lesser importance of the CP analysis for highly rated issuers. Nevertheless, the Supervision Department does not view this wording as being contradictory to the (...) statements of the 2015 CB methodology committing to the performance of a CP analysis also for highly rated issuers<sup>210</sup>”.

217. On this basis the Board, regarding the content of the 2015 CB Methodology, agrees with the IIO and overall considers that even though some statements are less clear, the reading of the 2015 CB Methodology leads to the conclusion that the application of the 2015 CB Methodology would imply the conduct of a cover pool assessment for all CB ratings, including highly rated issuers. In particular, as pointed out by ESMA’s Supervision Department<sup>211</sup>, an objective reader of the 2015 CB Methodology would expect the PSI to conduct this analysis for any CB rating.

218. The Board notes that the above arguments were not reiterated in the PSI’s written submissions. In particular, the Board notes that the Academic’s reading of the 2015 CB

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<sup>204</sup> Exhibit 68, PSI’s Response to the IIO’s Third RFI, Document “20160504 Memo call ESMA Scope Covered bond Rating action Sept 2015”, p.4.

<sup>205</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.1.

<sup>206</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.1. See also p.4.

<sup>207</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.10.

<sup>208</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, pp. 1, 10 and 12.

<sup>209</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, pp. 1 and 10.

<sup>210</sup> Exhibit 1, Supervisory Report, Paragraph 240.

<sup>211</sup> Exhibit 1, Supervisory Report, Paragraph 244.

Methodology<sup>212</sup> is in line with the basic assumption of the legal analysis presented to the Board in the past meetings. It reinforces the belief that the text of the methodology, despite some unclear and apparently contradictory sentences, includes the commitment of the PSI to conduct the cover pool analysis for all the ratings. As a clear consequence, the previous argument based on a different interpretation of the text of the methodology could not be reiterated in the written submissions.

219. Therefore, the Board strongly confirms that the identified statements imply the PSI's commitment to perform the cover pool analysis for all the ratings, including in the case of highly rated issuers.

220. In this respect, the Board also acknowledges that in its Response to the IIO's initial Statement of Findings, the PSI claimed that "(...) following the implementation of the BRRD in the Member States of the EU, (...) it was clear to market participants that the need for a cover pool assessment is remote (...) <sup>213</sup>" and as an example, the PSI attached a commentary of Deutsche Bank of April 2015 stating that "(...) the fact that a A- rated bank (depending on the covered bond framework and resolution regime analysis) can achieve a AAA rating without detailed analysis of the cover pool seems in line with covered bond frameworks (...) <sup>214</sup>". The Board acknowledges that the PSI reiterated the argument of the common market understanding in its written submissions<sup>215</sup>.

221. However, the fact that some market participants with professional experience such as Deutsche Bank agreed with the fact that in some circumstances it would seem appropriate not to have a detailed analysis of the cover pool does not at all change the conclusion that the 2015 CB Methodology (as it was drafted and adopted by the PSI and made available to the general public and investors) implied the conduct by the PSI of a cover pool assessment for all CB ratings, including highly rated issuers.

222. In addition, it can be noted that for example, regarding the assessment of overcollateralisation, the 2015 CB Methodology explains the circumstances in which this factor will not be taken into consideration: "Our analysis generally considers the currently available collateralisation if the issuer has an ICSR of at least BBB. (...) If the rating is below BBB, our decision to take into account the currently available overcollateralisation depends on whether the issuer engages in sufficiently robust capital-market communication on overcollateralisation levels in line with expectations<sup>216</sup>". This example illustrates that the text of the 2015 CB Methodology explains that in some circumstances, some types of analysis will not be taken into account.

223. This is not the case for the cover pool analysis, where on the contrary, the 2015 CB Methodology states that "a thorough analysis of the cover pool needs to be performed for

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<sup>212</sup> See written submissions, Academic Opinion, pp. 50-51.

<sup>213</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 16.

<sup>214</sup> Exhibit 219, PSI's Response to the IIO's initial Statement of Findings, Exhibit 1, DB\_EURLiqCredit\_2015-04-09, p. 2.

<sup>215</sup> See written submissions, p. 23.

<sup>216</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.13.

all rated covered bonds<sup>217</sup> and “Scope performs and publishes a detailed quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers<sup>218</sup>”. Based on the drafting of the 2015 CB Methodology, the thorough analysis of the cover pool should be performed for both highly and lowly rated issuers because it helps to understand the likely stability of the CB rating<sup>219</sup>.

224. Moreover, the Board considers relevant the fact that it was only in the version posterior to the 2015 CB Methodology that the possibility of a simplified cover pool analysis was foreseen<sup>220</sup>.

225. On that basis, the Board considers further supported the view that the 2015 CB Methodology, according to which the relevant CB ratings were issued, provided for a thorough cover pool analysis to be performed, irrespective of whether there were highly and lowly rated issuers.

226. The 2015 CB Methodology also did not make a distinction between solicited and unsolicited ratings in order to establish whether and which type of cover pool analysis was to be performed. The fact that the PSI had to rely on limited public information for issuing unsolicited ratings was not indicated in the 2015 CB Methodology as a reason for not performing the cover pool analysis.

#### Board’s analysis of whether the 2015 CB Methodology was systematically applied

227. It is clear from the relevant press releases that the PSI did not conduct the type of analysis of the cover pool foreseen by the 2015 CB Methodology for the CB ratings issued in September and November 2015, whereas it conducted a thorough analysis for the ratings of May and July 2016.

228. The press releases include the following statements (or very similar wording): “These ratings do not take into account the potential further credit support of up to three additional notches the cover pool analysis could provide<sup>221</sup>” and “[f]or the unsolicited ratings we have not analysed the cover pool’s credit quality, cash flow structure and whether the protection

<sup>217</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.9.

<sup>218</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.

<sup>219</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.

<sup>220</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, p.23. See also Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), p. 28.

<sup>221</sup> Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p. 1; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 73, Deutsche Bank’s mortgage covered bonds press release, p.1; Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, p.1.

levels provided (overcollateralisation) could support an additional credit differentiation of up to three additional notches<sup>222</sup>”.

229. In the assessment of the facts, the Board has thoroughly considered the following. When asked by ESMA’s Supervision Department to provide more detailed information on the type of analysis of the cover pool that the PSI had performed for the CB ratings issued on September and November 2015, the PSI replied that the most recent quarterly cover pool information that was publicly available was “reviewed to identify any potential non-standard features and with a view to the asset composition in the cover pool and overcollateralization<sup>223</sup>”. However, the PSI stated that “It was not deemed necessary at the time to conduct further analysis on the credit quality of each cover pool, the cash flow structure, potential counterparty risk and whether the protection levels provided (overcollateralisation) would support an additional credit differentiation of up to three additional notches<sup>224</sup>”. In addition, when asked to confirm that “in the rating actions of September and November 2015, no quantitative analysis concerning the credit and refinancing risk, cash flow modelling and Counterparty risk was performed<sup>225</sup>”, the PSI wrote that it “confirms that this is the case. (...) This implies that quantitative analysis of the covered bond to determine a possible cover pool rating uplift was not needed (...)”<sup>226</sup>. The PSI also stated that “Even though it was not required under Scope’s 2015 methodology, a qualitative review of the cover pools was conducted based on publicly available cover pool reports<sup>227</sup>”.

230. On that basis, the Board finds that, because the CB ratings issued in September and November 2015 did not comprise the type of analysis of the cover pool which was foreseen by the 2015 CB Methodology, while the CB ratings issued in May and July 2016 did (correctly) comprise it, this methodology was not applied systematically.

231. The Board turns to assess the existence of an objective reason for divergence that would justify the lack of quantitative cover pool analysis in the CB ratings issued in

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<sup>222</sup> Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p. 2; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p. 2; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 73, Deutsche Bank’s mortgage covered bonds press release, p.2; Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, pp. 2-3; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p. 3; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, pp. 2-3.

<sup>223</sup> Supervisory Report, Exhibit 83, 20170221\_Reply to request of documents on site\_cover email\_compliance officer, p.1.

<sup>224</sup> Supervisory Report, Exhibit 83, 20170221\_Reply to request of documents on site\_cover email\_compliance officer, p.1.

<sup>225</sup> Supervisory Report, Exhibit 61, ESMA Response 1Sept2017, p.1.

<sup>226</sup> Supervisory Report, Exhibit 61, ESMA Response 1Sept2017, p.1.

<sup>227</sup> Supervisory Report, Exhibit 61, ESMA Response 1Sept2017, p.2. To be noted that the PSI made reference to the public information that was available at the time of the ratings under the 2015 CB Methodology (see Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 20). To be noted that in its Response to the IIO’s initial Statement of Findings (Exhibit 216, 24 June 2019, para. 20), the PSI also referred to “the sequence of credit rating actions that were taken on Deutsche Bank” and in this respect, to the cover pool analysis conducted by the PSI “based on such publicly available data after the bank rating was put on review for downgrade-status”. However, the IIO observes that the rating on Deutsche Bank’s mortgage-covered bonds was affirmed under a different methodology (i.e. the 2017 CB Methodology). In IIO’s view, the fact that the PSI analysed the cover pool to affirm the rating under the 2017 CB Methodology does not mean that the 2015 CB Methodology was systematically applied when the rating of Deutsche Bank was first assigned in September 2015.

September and November 2015 and would therefore exclude the infringement of Article 8 (3) of the Regulation. The Board turns to assess the existence of an objective reason for divergence that would justify the lack of quantitative cover pool analysis in the CB ratings issued in September and November 2015 and would therefore exclude the infringement of Article 8 (3) of the Regulation.

#### Considerations about the objective reasons for divergence

232. Based on the drafting of Article 5(1) of the Delegated Regulation, the principle is that all relevant credit ratings in an asset class / market segment are to be issued according to the methodology, the existence of an objective reason for divergence being the only exception to this requirement.

233. Regarding the notion of “objective reasons”, there is no definition provided in the Delegated Regulation. The Board acknowledges that ESMA’s Supervision Department indicated that in its views, this concept is linked to ensuring ratings quality<sup>228</sup>, “objective reasons cannot be based on contingent circumstances faced by a CRA, like, for instance, the lack of models or tools to perform the analysis required by a methodology<sup>229</sup>” and that “The Delegated Regulation and the Regulation do not fix a maximum acceptable number or threshold of ‘accepted’ divergences from a methodology, as they require to ascertain that there are objective reasons for each divergence<sup>230</sup>”.

234. The Board also acknowledges that according to the case-law of the Court of Justice of the European Union (“CJEU”), in interpreting a provision of EU law, it is necessary to consider not only its wording but also the context in which it occurs and the objectives of the rules of which it is part<sup>231</sup>. More precisely, the CJEU ruled that when a concept, such as the one of “objective reasons”, is not defined in the EU act, the meaning and scope of this concept has to be determined on the basis of the objective pursued by that EU act and of the particular clause referring to that concept<sup>232</sup>.

235. The Regulation and, in particular, its Article 8(3), for which the Delegated Regulation lays down the rules to be used in the assessment of compliance of credit rating methodologies, has as objectives to ensure the transparency of methodologies and practices, procedures and processes of CRAs<sup>233</sup> and that all credit ratings issued by the CRAs registered in the EU are of adequate quality and issued by CRAs subject to stringent requirements<sup>234</sup>.

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<sup>228</sup> Exhibit 1, Supervisory Report, Paragraph 259.

<sup>229</sup> Exhibit 1, Supervisory Report, Paragraph 260.

<sup>230</sup> Exhibit 1, Supervisory Report, Paragraph 261.

<sup>231</sup> See for example CJEU, Case C-17/03, VEMW e.a., 7 June 2005 and CJEU, Case C-323/03, Commission v. Spain, 9 March 2006.

<sup>232</sup> See for example CJEU, Case C-212/04 Konstantinos Adeneler e.a. v. ELOG, 4 July 2006.

<sup>233</sup> See, for instance, Recital 37 of the Regulation.

<sup>234</sup> See, for instance, Recital 2 of the Regulation.

236. In addition, the Board agrees with the IIO and is of the view that the possibility of diverging from a methodology on the basis of objective reasons should be interpreted in a narrow way. According to settled case-law<sup>235</sup>, exemptions are to be interpreted strictly since they constitute exceptions to general principles. In this respect, an objective reason should exist for each divergence with the methodology.

Board's analysis of whether there were objective reasons for divergence in the present case

237. Preliminary, the Board notes that, according to the PSI, the present analysis would not be necessary, since no divergence was put in place.

238. In particular, in the PSI's view, the relevant provisions (in particular Points 2(b) and 5 of Part I of Section D of Annex I of the Regulation) would imply that it is legitimate for a CRA, in applying the methodology to a specific credit or transaction, to deviate from the methodology itself, provided this is addressed and explained in the relevant press releases.

239. The PSI added that "Each rating committee (...) applies its own judgement in determining whether or how to emphasize specific rating factors that it considers to be of particular significance for a particular credit or transaction, as stipulated in the rating methodology, and therefore, not all elements always have to be analysed with the same rigor, as their impact on the achievable credit rating may vary<sup>236</sup>". This would be supported according to the PSI by the practice of other CRAs<sup>237</sup> as well as by Points 2(b) and 5 of Part I of Section D of Annex I of the Regulation<sup>238</sup>.

240. Overall, given the fact that the press releases accompanying the ratings clarified that the cover pool analysis was not performed, the PSI claimed that no divergence from the methodology was put in place.

241. On the same aspect, the PSI indicated that it "did not diverge from the application of the 2015 Methodology with reference to the covered bond rating actions of September and November 2015 and confirms that the ratings were assigned at the right level at the time and in line with the methodology<sup>239</sup>". It also added that it "(...) does not agree (...) that the lack of assessment of the CP in all 2015 CB rating actions constituted a divergence from the 2015 CB methodology (...) <sup>240</sup>".

242. In this regard, the Board's view on these arguments of the PSI, in line with those of the IIO, is the following:

243. Point 5 of Part I of Section D of Annex I of the Regulation provides that "When announcing a credit rating or a rating outlook, a credit rating agency shall explain in its press releases or reports the key elements underlying the credit rating or the rating

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<sup>235</sup> See for example CJEU, Case C-33/11, A Oy, 19 July 2012.

<sup>236</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.4. See also p.7.

<sup>237</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.4 and footnote 1.

<sup>238</sup> Exhibit 8, PSI's Comments on the Supervisory Report, pp. 4 and 5.

<sup>239</sup> Supervisory Report, Exhibit 61, ESMA Response 1Sept2017, p.10.

<sup>240</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.12.



outlook”. In the Board’s view, indicating in a press release (or a report) the key elements underlying a credit rating in accordance with Point 5 of Part I of Section D of Annex I of the Regulation is a requirement regarding the information to the public about the main elements that underlie a specific rating issued by a CRA. It does not at all imply that a CRA is allowed to completely disregard an element which was provided for in the relevant methodology because this would be in breach of its obligations regarding the systematic use of methodologies.

244. Regarding the practices of other CRAs, the Board notes that this is not proved, and, in any case, it cannot be considered as relevant in the present assessment.

245. Moreover, Point 2(b) of Part I of Section D of Annex I of the Regulation provides that “(...) where the credit rating is based on more than one methodology, or where reference only to the principal methodology might cause investors to overlook other important aspects of the credit rating, including any significant adjustments and deviations, the credit rating agency shall explain this fact in the credit rating (...)”. According to the PSI, this provision implies that “(...) it is legitimate for a credit rating agency, in applying a rating methodology to a specific credit or transaction, to deviate from a given methodology provided that this is addressed and explained in the press release when issuing that particular credit rating action<sup>241</sup>”. The PSI also indicated that if “(...) there was no discretion for the credit rating agency when applying the methodology to consider which factors are, from an analytical perspective, the drivers of the rating for a specific credit or transaction, the need to disclose adjustments or deviations at the level of the credit rating action would be rendered completely unnecessary<sup>242</sup>”.

246. On this point, the Board notes that indeed, the relevant press releases about the rating actions issued under the 2015 CB Methodology for which no cover pool assessment was conducted did contain a statement about this lack of cover pool analysis<sup>243</sup>. However, this does not solve the problem that this divergence was not justified by an objective reason. Point 2(b) of Part I of Section D of Annex I of the Regulation sets a requirement to inform the public about deviations to the published methodology and *prima facie*, the PSI does not seem to have breached this requirement of information to the public. However, this provision in no way allows a CRA to deviate from a methodology for any reason; otherwise, the requirement of systematic application of methodologies would have no substance. As

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<sup>241</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.5.

<sup>242</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.7.

<sup>243</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 73, Deutsche Bank’s mortgage covered bonds press release, p.2; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating p.3; Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, pp. 2 and 3; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, pp. 2 and 3.

clarified above, divergence is possible only under Article 5(1) of the Delegated Regulation and only if there are “objective reasons”, this concept being interpreted in a strict way.

247. In conclusion, the Board confirms that for the divergence to be legitimate, there must be the existence of an objective reason and rejects the argument of the PSI according to which the transparency in the press releases grants per se legitimacy to the divergence must be rejected.

248. In the assessment of the existence of an objective reason for divergence, the Board considers the two main reasons raised by the PSI for not performing the cover pool analysis in the case of unsolicited ratings: i) the fact that the necessary data were not available (given that the ratings were unsolicited); ii) there was no need for a detailed cover pool analysis, because the primary rating driver was already strong enough to support the AAA rating.

*Regarding the PSI's justification that the necessary data were not available*

249. The Board acknowledges that the ratings of September and November 2015 were unsolicited. However, the Board agrees with the IIO and considers that the fact that these ratings were unsolicited and that relevant data might have been missing cannot be considered as an objective reason to diverge from the 2015 CB Methodology.

250. In particular, the Board notes that Point 4, second paragraph, of Part I of Section D of Annex I of the Regulation provides that “In a case where the lack of reliable data or the complexity of the structure of a new type of financial instrument or the quality of information available is not satisfactory or raises serious questions as to whether a credit rating agency can provide a credible credit rating, the credit rating agency shall refrain from issuing a credit rating or withdraw an existing rating”. This is consistent with the 2015 CB Methodology itself which states that a withdrawal of a CB rating can take place if “There is insufficient information available to Scope to maintain the credit analysis underpinning the rating<sup>244</sup>”.

251. On this basis, the supervisor's expectation would have been that the PSI, in case of lack of available information, would have refrained from issuing the ratings.

252. In the Board's view, if the PSI considered that because the CB ratings were unsolicited, the available data was insufficient to analyse the cover pool in a way that would be consistent with the 2015 CB Methodology, it should have refrained from issuing these ratings, rather than deciding to diverge from the 2015 CB Methodology to nonetheless issue these ratings. The unsolicited nature of the ratings and the lack of available information cannot be regarded as an objective reason. It was clearly up to the PSI to decide not to issue those ratings if the 2015 CB Methodology could not be applied systematically.

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<sup>244</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.16.

253. The Board also notes that the ratings for which the PSI did not conduct the cover pool analysis foreseen in the 2015 CB Methodology constitute 559 ratings out of the 622 ratings which were assigned on the basis of the 2015 CB Methodology<sup>245</sup>, i.e. they were not an exception in terms of figures, despite the fact that the concept of “objective reasons” should be given a strict interpretation.
254. Moreover, in the present case there is evidence that the PSI was aware, before the adoption of the 2015 CB Methodology and since the beginning of its CB rating activities, about the fact that in case of unsolicited ratings the available data would be limited or missing.
255. In particular, in its presentation in December 2014 about CB criteria the PSI reported that it would have to: “identify ‘friendly’ Issuers that are willing to share current rating data with us to establish modelling capabilities” and “identify less complex covered bond structures to avoid CBM’s [chief business manager] establishing mandates that currently are too complex for us (...)”.
256. The rationale behind the above statements was the following: “according to the PSI, when it started its rating activities regarding CB, there was “limited proprietary data available at Scope at that time due to its small market share”, and therefore “it seemed important from an analytical perspective to identify issuers who would be willing to share such information in order for the analytic team to perform a high-quality analysis”. Furthermore, the PSI indicated that “(...) in light of the small amount of public information for all possible assets in a cover pool, (...) the analysts were aware that at the initial stage of establishing a pool of CB ratings it would not seem appropriate to start with the most complex covered bond structures”.
257. On this basis, the Board considers that the fact that these ratings were unsolicited, and the relevant data might have been missing, cannot be considered as an objective reason to diverge from the 2015 CB Methodology.
258. In fact, the objective reason justifying the divergence from the systematic application of the rating methodology should be identified in an objective situation that occurs in the moment of the use (i.e. application of the methodology). If the potential situation is known at the moment of the adoption of the methodology (as in the present case), it has to be integrated and explained in the methodology itself. On this basis, it remains clear that the expectation of ESMA was that the PSI, in case of lack of available information, would have refrained from issuing the ratings instead of issuing them without the performance of the cover pool analysis.
259. On the basis of the above reasoning, the Board rejects the PSI’s argument that “(...) it cannot be argued that the PSI should have refrained from the unsolicited ratings under the

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<sup>245</sup> See Exhibit 14, PSI’s Response to the IIO’s Second RFI, Question 2. The figures provided in the Supervisory Report (Paragraph 269) of 527 unsolicited ratings out of 577 ratings assigned based on the 2015 CB Methodology were rectified by the PSI.

2015 CB Methodology. This would have only been necessary, if the available data had not been sufficient for a rating<sup>246</sup>".

260. In its Response to the IIO's initial Statement of Findings, the PSI stated that "(...) it is not correct that [the PSI] would not have been able to conduct a cover pool analysis based on publicly available cover pool information.<sup>247</sup>".

*Regarding the PSI's justification that there was no need for a detailed cover pool analysis for highly rated issuers*

261. Turning to the second reason given by the PSI, the Board notes that in the PSI's views, "(...) there was no need for a detailed CP analysis for the 2015 CB rating actions because the primary rating driver was already strong enough to support a AAA rating (...) <sup>248</sup>" and "Taking into account that, whilst a rating methodology seeks to capture all aspects that could potentially become analytically relevant within the broader universe of credits or transactions that fall into the scope of that respective rating methodology, the application of that methodology would primarily look at the rating drivers for a particular credit or transaction at that time<sup>249</sup>".

262. The PSI also argued that the ratings regarding CB issued by Dexia and Bankia of respectively 4 May 2016 and 8 July 2016 "(...) were significantly different since these ratings did not reach AAA based solely on the legal and resolution regime (...). Therefore, further uplift from the CP analysis was possible in those 2016 CB ratings and as a consequence, it was deemed relevant to conduct such CP analysis as a potential rating driver, in line with Scope's 2015 CB methodology<sup>250</sup>".

263. The Board notes that the potential situation of highly rated issuers had already been considered by the PSI in drafting the 2015 CB Methodology.

264. In particular, the Board notes the following statement of the Methodology: "The benefit of the cover pool is limited but it provides additional security and stability to the rating. (...) Scope performs and publishes a detailed quantitative analysis of the cover pool for programmes for both highly and lowly rated issuers".

265. In fact, the cover pool analysis, under the 2015 CB Methodology, can further enhance the CB rating by up to three notches (i.e. above the maximum six-notches uplift provided by the first analytical building block). As clarified by the PSI itself in several press releases accompanying the ratings, "A negative development of the issuer rating or the outlook could impact the rating of the covered bonds if the additional benefit the cover pool analysis – which could provide an additional credit support of up to three notches - is not taken into

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<sup>246</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 51.

<sup>247</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, 24 June 2019, para. 19.

<sup>248</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.11.

<sup>249</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.11.

<sup>250</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.12.

account". The cover pool analysis, under this reasoning, would have been particularly necessary in case of absence of rating buffer.

266. From the evidence gathered it is clear that, even in those cases where there was no rating buffer, the PSI did not perform a cover pool analysis. This is clearly explained in the press release of the ratings of Danske Bank's covered bonds of 22 September 2015. The same is true with respect to the ratings of Swedbank Mortgage AB's covered bonds of 26 November 2015. Overall, the Board finds that the 2015 CB Methodology was not applied systematically by the PSI and the alleged lack of available information for unsolicited ratings does not constitute an objective reason to diverge from the 2015 CB Methodology.
267. The Board, in its assessment, considers relevant the IIO's view that where there was no buffer it is clear that conducting the cover pool analysis in accordance to the 2015 CB Methodology would have provided very useful information to the PSI (and investors) regarding the stability of the ratings.
268. Moreover, it is evident that, despite the possibly limited impact, at a given point in time, of the cover pool analysis in case of highly rated issuers, the PSI committed to perform it in any case. If the PSI did not find it relevant to conduct the cover pool assessment for highly rated issuers, it should have made this clear in the methodology itself, instead of committing to perform the assessment also for highly rated issuers (in fact, it is what the PSI did amending the methodology in July 2016).
269. The Board finds necessary to reiterate that the systematic application of the 2015 CB Methodology implied the conduct of a cover pool assessment for all CB ratings. As indicated in the 2015 CB Methodology, "the covered bond rating methodology rests on two analytical building blocks (...) the second is the cover pool analysis<sup>251</sup>"; "a thorough analysis of the cover pool needs to be performed for all rated covered bonds<sup>252</sup>" and "Scope performs and publishes a detailed quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers<sup>253</sup>". The fact that a high rating could already be achieved without the need to consider the cover pool cannot be considered in the Board's view as an exception and an objective reason to diverge as it nullifies the 2015 CB Methodology on the point related to the cover pool analysis. If the PSI did not find it relevant to conduct a cover pool assessment for highly rated issuers, it should have made this clear in the 2015 CB Methodology itself. In fact, this is one of the changes introduced to the CB Methodology in July 2016. However, as long as this was not provided for by the 2015 CB Methodology, its systematic application implied the conduct of the cover pool analysis.

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<sup>251</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond Rating methodology, p. 17.

<sup>252</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 9.

<sup>253</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p. 5.

270. The Board, in support of its findings, also notes that a number of ratings issued under the 2015 CB Methodology did not have any buffer but nevertheless the PSI did not conduct the assessment of the cover pool which was foreseen by the 2015 CB Methodology.
271. For example, the PSI confirmed that there was no buffer for some of the ratings issued on 22 September 2015 and 26 November 2015<sup>254</sup>. The PSI indicated that, in case of downgrade of the ICSR or legal and resolution regime, it would have had to perform a cover pool analysis on the basis of the available information<sup>255</sup>. This could have resulted in an affirmation or a downgrade depending on the cover pool analysis, or if the information on the cover pool would have been insufficient, a placement of the rating under review while searching for further information and potentially a withdrawal if the information remains insufficient.
272. The Board acknowledges that the IIO noted in this respect that as those ratings were unsolicited, the information on the cover pool seems to have been insufficient to perform the analysis of the cover pool at the time of the issuing of the ratings. Thus, it is far from clear that the available information would be sufficient later-on, at the time of the downgrade of the ICSR or legal and resolution regime.
273. More precisely, for example, the CB rating assigned to BBVA on 22 September 2015 did not benefit from a rating buffer<sup>256</sup>. As stated in the relevant press release, “the lower uplift for Spanish public sector covered bonds means that any negative credit development of the issuer could impact the covered bond ratings<sup>257</sup>”. Similarly, for the ratings assigned to Danske Bank on 22 September 2015<sup>258</sup> and to Swedbank Mortgage AB on 26 November 2015<sup>259</sup>, there were no rating buffers available, but the PSI decided not to carry out the cover pool analysis. The Board considers extremely relevant the fact that the press releases of these ratings indicate that a negative development of the issuer rating “could impact the rating of the covered bonds if the additional benefit [of] the cover pool analysis – which could provide an additional credit support up to three notches – is not taken into account”.
274. For these ratings where there was no buffer, it is clear that conducting an analysis of the cover pool in accordance with the 2015 CB Methodology would have provided very useful information to the PSI (and investors) regarding the stability of the ratings.
275. Given the above, the Board finds that it is impossible to consider the situation of the primary rating driver already strong enough to support the AAA rating as an objective reason to diverge from the consistent application of the 2015 CB Methodology.

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<sup>254</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 5.

<sup>255</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 5. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 6.

<sup>256</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 6.

<sup>257</sup> Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating, p.3.

<sup>258</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating.

<sup>259</sup> Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating.



276. Besides the main reasons given, the PSI further stated that “There was an objective reason as, following the 2015 CB methodology, a quantitative analysis of the CP would have had no impact on the rating. (...), it was not necessary to carry out a thorough quantitative analysis of the CP and a CRAs level of discretion at the level of the application of a methodology has to be linked to the principle of proportionality. Credit rating agencies cannot be forced – by means of penalties – to strictly apply every aspect of a methodology, if it is obvious that this aspect has no impact on the rating<sup>260</sup>”.

277. The Board rejects also this argument on the basis of the consideration that for the purpose of the exclusion of the infringement, the lack of impact on the rating is completely irrelevant, in application of the relevant provisions. However, the fact that a quantitative analysis of the cover pool would have had no impact on the rating has been duly considered by the IIO in the calculation of the proposed fine. In fact, she did not propose the application of the aggravating factor (aggravating coefficient of 1,5 in case the infringement had a negative impact on the quality of the ratings).

278. In this regard, the Board acknowledges that the PSI, in the context of the written submissions to the Board, developed a partially new argument. The Board’s analysis of the written submissions is developed below.

#### Was the behaviour of the PSI incorrect?

279. Even in case of a ‘broad’ interpretation of Art. 8(3) (i.e. covering also the application phase), the PSI argues that the PSI did not apply the methodology incorrectly/unsystematically, even if it diverged from the described methodology.

280. For the PSI there are two possible understandings of a systematic application<sup>261</sup>:

- a. ESMA’s ‘narrow’ understanding: every step of the methodology has to be completed, whether or not it can be of any relevance for the rating outcome, unless otherwise provided in the methodology.
- b. ‘Broad understanding’: every step of a rating methodology has to be completed until it is obvious that any further step could not change the outcome of the rating.

281. According to the PSI, the broad understanding would be preferable, since performing superfluous activities would not be in line with the objective of the CRA Regulation to promote small CRAs.

282. On this basis, the PSI considers that, in the issuances of September and November 2015, the PSI did not behave incorrectly, because the lack of performance of the CP analysis in case of AAA ratings responded to the need to avoid useless steps and waste of resources.

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<sup>260</sup> Exhibit 14, PSI’s Response to the IIO’s Second RFI, Question 3.

<sup>261</sup> See written submissions to the Board, pp. 53, 60-61.

283. This is only a partially new argument, linked to the previous PSI's justification regarding the lack of need to conduct the cover pool analysis, because the AAA rating was already reached thanks to the first recourse analysis. This issue has already been thoroughly analysed above and discarded. However, the Board has reconsidered it from a legal perspective, given its new legal frame.

#### *Board's analysis*

284. This point can be easily discarded, on the basis of three main arguments, mainly derived from the same academic legal opinion used by the PSI.

285. Preliminary, it is highlighted that the defensive argument is constructed on the assumption that the 'broad understanding' is to be preferred, while the same legal opinion is not so straightforward in respect of the conclusion in favour of it. On the contrary, it definitely seems to reject it<sup>262</sup>, because this reading would allow flexibility and discretion to the rating agency in the deviation from its rating methodology and could lead to a softening of the provisions of the CRA Regulation. Moreover, it is recognised that "The methodology would run the risk of being washed out and no longer being understandable for rating users. Likewise, the risk of courtesy ratings would increase if critical parts of a method could be excluded".

286. Then, the academic legal opinion states<sup>263</sup> that "To not carry out a cover pool analysis in such a case means that this finding (of the cover pool analysis being useless in this case) would be immediately incorporated into the method – however, the methodology must explicitly provide for such an action". It is therefore clear, also on the basis of the legal opinion, that in the case at stake it was not admissible, for the PSI, to avoid the cover pool analysis.

287. Finally, it is fundamental to consider that while the CP analysis is defined by the PSI as 'useless step', 'superfluous activity' in the case of AAA ratings, in fact, the 2015 CB methodology clearly defined it as necessary. It was a self-imposed decision by the PSI. This is also recognised in the legal opinion<sup>264</sup>. The Board notes that only in the 2016 revised version of the methodology, these steps have been considered optional.

288. The Board, having thoroughly analysed the written submissions of the PSI, confirms its findings and strongly rejects the PSI's arguments.

289. Further to that, the Board notes that in its Response to the IIO's initial Statement of Findings, the PSI stated that "(...) it is not correct that [the PSI] would not have been able to conduct a cover pool analysis based on publicly available cover pool information. It was rather the PSI's understanding at the time that, for the credit ratings that were active in

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<sup>262</sup> See written submissions to the Board, academic opinion, pp. 61-62.

<sup>263</sup> See written submissions to the Board, academic opinion, p. 54.

<sup>264</sup> See written submissions to the Board, academic opinion, pp. 50-51.

2015, no such analysis constituted a driver for the credit rating decision and that an analysis would be carried out as and when it became relevant for the credit rating decision<sup>265</sup>”.

290. The Board reiterates the subjective interpretation of the analysis is irrelevant in the assessment of the systematic application of the methodology and in the analysis of an objective reason for divergence and therefore must be rejected. This is valid also if the case of the understanding applied without exceptions (i.e. in all cases of highly rated issuers).

291. The Board thoroughly considered the following further PSI’s arguments.

292. In its Response, the PSI stated that “An exemption cannot necessarily support the same objectives in the same way as the rule<sup>266</sup>” and “Exemptions can alleviate the effects of an obligation to ensure its compatibility with the principle of proportionality<sup>267</sup>”. In addition, the PSI referred to “(...) the settled case-law regarding the principle of equal treatment and its exemptions<sup>268</sup>” and concluded that “the term “objective reasons” has to be interpreted in a way that (i) the divergence in question has to pursue a legally permitted objective, which is not necessarily the same objective pursued by the systematic application of the methodology and (ii) it has to be proportionate to the objective<sup>269</sup>”. Trying to apply the test that it has itself defined, the PSI then claimed in its Response to the IIO’s initial Statement of Findings that “(...) the missing relevance for the rating can constitute an objective reason for divergence as long as it is made public<sup>270</sup>”. According to the PSI, “(...) the lack of a cover pool assessment enabled the PSI to issue an unsolicited CB rating. It is one of the objectives of the Regulation to enable unsolicited ratings in order to encourage competition<sup>271</sup>”. The PSI also stated that “(...) the flexibility gave the PSI the possibility to exercise its freedom to conduct business (...)”<sup>272</sup>”.

293. Furthermore, in the Response to the IIO’s initial Statement of Findings, the PSI stated that “(...) the mentioned objectives of the Regulation, i.e. to ensure transparency of the actions taken and adequate quality of the issued ratings, were not jeopardized (...)”<sup>273</sup>”.

294. The Board endorses the analysis of the IIO and makes the following considerations.

295. First, the Board has strong doubts as to whether the case-law put forward by the PSI regarding the principle of equal treatment and its exemptions is at all relevant in this case for the interpretation of “objective reasons” for the purpose of the Regulation. Indeed, in the Response to the IIO’s initial Statement of Findings, the PSI referred to cases where in

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<sup>265</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, 24 June 2019, para. 19.

<sup>266</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 44.

<sup>267</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 46.

<sup>268</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 47.

<sup>269</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 48.

<sup>270</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 50.

<sup>271</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 51.

<sup>272</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 51.

<sup>273</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 52.

an EU legislative act, there is a difference in treatment between persons that are in similar situations, which is not the case here.

296. In any event, the Board strongly disagrees with the PSI's assertion that "the missing relevance for the rating can constitute an objective reason for divergence". As indicated above, the 2015 CB Methodology did not make any distinction about highly and lowly rated issuers. If the PSI considered that for the ratings of covered bonds of highly rated issuers it was unnecessary to perform an analysis of the cover pool, this should have been expressly set out in the 2015 CB Methodology. However, under the 2015 CB Methodology, the analysis of the cover pool had to be carried out in all instances. It is therefore not relevant to the IIO's assessment of the infringement whether, depending on the ICSR of the CB issuer, the latter could achieve a AAA rating just based on the analysis of the legal framework and the resolution regime (the fundamental analysis). On the basis of the 2015 CB Methodology, even in those cases, the PSI had to perform an analysis of the cover pool.
297. In addition, regarding the objectives that the PSI claimed to have pursued when diverging from the 2015 CB Methodology (i.e. fostering competition and ensuring the exercise of the freedom to conduct business), they cannot justify in the Board's view the non-application by the PSI of its obligations to use systematic methodologies.
298. Regarding the promotion of competition between CRAs through unsolicited ratings (as mentioned in Recital 7 of the CRA II Regulation), the Regulation does not state that, to promote the issuance of unsolicited ratings, the standards to issue this type of ratings should be somewhat more relaxed than the ones applicable to issue solicited ratings. Regarding the freedom to conduct business, according to the established case-law, restrictions may be imposed on its exercise, provided that they correspond to objectives of general interest and do not constitute a disproportionate and intolerable interference in relation to the aim pursued, impairing the very substance of the rights guaranteed<sup>274</sup>. As indicated by Recital 75 of the Regulation, the different obligations applicable to CRAs under the Regulation (including the obligation to use systematic methodologies) are in accordance with the principle of proportionality and do not go beyond what is necessary to achieve its objectives. Especially given the fact that it was the PSI itself who drafted the 2015 CB Methodology.
299. Moreover, the fact that according to the PSI, some of the objectives of the Regulation (i.e. transparency and adequate quality of the ratings) were not jeopardised, which in any event remains to be established, does not change this conclusion. It is obvious that an infringement could exist even if some of the objectives of the Regulation were not impaired. For example, in the Regulation, the impact of the infringement on the quality of the issued ratings is on the contrary taken into consideration as an aggravating factor once the infringement is established.

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<sup>274</sup> See, for instance, Judgement of 9 September 2004, Spain and Finland v Parliament and Council, Joined Cases C-184/02 and C-223/02, ECLI:EU:C:2004:497, paras. 52 to 54.

300. In conclusion, the Board agrees with the IIO and rejects the arguments put forward by the PSI regarding the systematic application of the 2015 CB Methodology.

301. Overall, the Board confirms that the systematic application of the 2015 CB Methodology would have implied the conduct of a cover pool assessment for all CB ratings, whereas at very numerous occasions, the PSI did not assess the cover pool for the issuance of CB ratings under the 2015 CB Methodology. None of the arguments given by the PSI are considered by the Board as an objective reason to diverge from the systematic application of the 2015 CB Methodology.

302. Thus, the infringement of Point 43 of Section I of Annex III of the Regulation is established by the Board.

### **Intent or negligence**

303. Article 36a(1) of the Regulation provides as follows:

“Where, in accordance with Article 23e(5), ESMA’s Board of Supervisors finds that a credit rating agency has, intentionally or negligently, committed one of the infringements listed in Annex III, it shall adopt a decision imposing a fine in accordance with paragraph 2”.

“An infringement by a credit rating agency shall be considered to have been committed intentionally if ESMA finds objective factors which demonstrate that the credit rating agency or its senior management acted deliberately to commit the infringement”.

304. In accordance with Article 36a(1) of the Regulation, a finding that an infringement has been committed by a CRA with intention or negligence will lead to the imposition of a fine by the Board of Supervisors.

305. In accordance with Article 36a(1) of the Regulation, a finding that an infringement has been committed intentionally requires a finding of “objective factors which demonstrate that the credit rating agency or its senior management acted deliberately to commit the infringement”.

306. The Board notes that in a number of documents, there are references to “regulatory requirements”, which may cast doubts on PSI’s willingness to abide by the rules. For example, the Board notes the following quotes: “For regulatory as well as practical reasons the covered bond criteria framework therefore has to be written rather generic to cater for the variances we have to expect<sup>275</sup>”; “If possible, we should avoid classifying those “formalizations” as criteria due to the regulatory criteria publication process as well as the requirement to review criteria on an ongoing – typically annual basis. Rather these documents should be classified as “guidance” or else – which of course would also allow us to amend further develop those without any additional “request for comment” or alike

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<sup>275</sup> Supervisory Report, Exhibit 9, II\_20141024\_Covered Bond criteria project - v 1 0\_Kickoff Meeting, p.2.

regulatory processes<sup>276</sup>". When asked by the IIO to explain what was meant by these references to "regulatory / regulatory requirement / regulatory processes", the PSI indicated in particular that "references to "regulatory" / "regulatory requirements" and "regulatory processes" were at the time used by analysts in an untechnical manner and were therefore not meant as a reference to specific provisions in the CRA Regulation. These terms were rather based on the respective analysts' general understanding of requirements as they were implemented in Scope's internal policies at the time and therefore terms such as "regulatory requirements" were also used to point to certain requirements in Scope's policies and procedures. These references are sometimes also reflecting the individual knowledge and / or past experience of a respective analyst gained at another CRA<sup>277</sup>".

307. On that basis, taking into consideration the explanations given by the PSI and above all, the fact that there is not in the file other elements indicating PSI's intent in relation to the subject matter of the present case, the Board agrees with the IIO in considering that the factual background as set out in this Statement of Findings does not establish that there are objective factors which demonstrate that the PSI, its employees or senior managers acted deliberately to commit the infringement of Point 43 of Section I of Annex III of the Regulation.

308. It should therefore be assessed whether there was negligence.

### **Preliminary remarks**

309. The Board notes that there is no explicit guidance as regards the concept of "negligence" in the Regulation. However, it is clear from the provisions of Articles 24 and 36a of the Regulation that the term "negligence" as referred to in the Regulation requires more than a determination that there has been the commission of an infringement.

310. Further, it is clear from the second subparagraph of Article 36a(1) of the Regulation that a negligent infringement is not an infringement which was committed deliberately or intentionally. This position is further reinforced by the case-law of the CJEU which ruled that negligence may be understood as entailing an unintentional act or omission<sup>278</sup>.

311. In addition, "negligence" in the context of the Regulation is an EU law concept – albeit a concept which is familiar to and an inherent part of all the Member States' legal systems – which must be given an autonomous and uniform interpretation.

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<sup>276</sup> Supervisory Report, Exhibit 9, II\_20141024\_Covered Bond criteria project - v 1 0\_Kickoff Meeting, p.2.

<sup>277</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 2. See also Question 11.

<sup>278</sup> See for instance Judgement of 3 June 2008, International Association of Independent Tanker Owners (Intertanko) and Others v Secretary of State for Transport, Case C-308/06, ECLI:EU:C:2008:312, where the CJEU noted at para. 75 of its judgment that all of the Member States' legal systems "have recourse to the concept of negligence which refers to an unintentional act or omission by which the person responsible breaches his duty of care".



312. Taking into account the CJEU jurisprudence<sup>279</sup>, the concept of a negligent infringement of the Regulation is to be understood to denote a lack of care on the part of a CRA when it fails to comply with this Regulation.
313. Based on this, the Board will consider negligence to be established in circumstances where the CRA, as a professional firm in the financial services sector subject to stringent regulatory requirements, is required to take special care in assessing the risks that its acts or omissions entail, and has failed to take that care; and as result of that failure, the CRA has not foreseen the consequences of its acts or omissions, including particularly the infringement of the Regulation, in circumstances when a person in such a position who is normally informed and sufficiently attentive could not have failed to foresee those consequences.
314. The following points should be taken into consideration regarding the standard of care to be expected of a CRA:
315. First, the position taken by the General Court in the Telefonica case must be considered. In this case, the General Court spoke of persons “carrying on a professional activity, who are used to having to proceed with a high degree of caution when pursuing their occupation. They can on that account be expected to take special care in assessing the risks that such an activity entails<sup>280</sup>”. Similarly, it is considered that, operating within the framework of a regulated industry, a CRA, which holds itself out as a professional entity and carries out regulated activities, should be expected to exercise special care in assessing the risks that its acts and omissions may entail.
316. Second, regard should be given to the nature and significance of the objectives and provisions of the Regulation. In this respect, Recitals 1 and 2 of the Regulation emphasise the important role and impact of CRAs in global securities and banking markets, the resulting essential need for credit rating activities to be conducted in accordance with principles of integrity, transparency, responsibility and good governance, and the resulting intention of the legislator to provide stringent requirements in relation to the conduct of CRAs. Further, the weight given to these considerations by the legislator is reflected by the nature and extent of the requirements imposed on CRAs under Annex I of the Regulation and by the corresponding infringement provisions under Annex III of the Regulation. Moreover, of more particular note, the Regulation envisages that an important function of a CRA is to ensure that it monitors its own activities in order to comply with the Regulation and in order to identify instances in which its present practices carry the risk of non-compliance with the Regulation. For instance, the requirement for a CRA to have sound

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<sup>279</sup> See, for instance, Judgement of 11 November 1999, *Firma Söhl & Söhlke v Hauptzollamt Bremen*, Case C-48/98, ECLI:EU:C:1999:548, para. 58; Judgement of 26 June 1990, *Hauptzollamt Giessen v Deutscher Fernsprecher*, Case C-64/89, ECLI:EU:C:1990:261, para. 19.

<sup>280</sup> See Judgement of 29 March 2012, *Telefónica, SA and Telefónica de España, SA v Commission*, Case T-336/07, ECLI:EU:T:2012:172, para. 323.

administrative or accounting procedures, internal controls mechanisms or to establish and maintain a compliance function reflects the importance of this function.

317. Therefore, on this basis, the standard of care to be expected of a CRA is high.

318. This high standard of care has been confirmed by the Joint Board of Appeal (“BoA”) of the European Supervisory Authorities, which has stated<sup>281</sup> that “ESMA rightly emphasises that financial services providers and CRAs play an important role in the economy of the EU, as well as in the financial stability and integrity of the financial markets” and that “[a] high standard of care is to be expected of such persons”.

319. Finally, the Board notes that in its Response to the IIO’s initial Statement of Findings, the PSI indicated that “In general, we agree with the definition of negligence put forward by the IIO. However, it is important to stress that the lack of care has to be linked to the alleged infringement<sup>282</sup>”. In this respect, the Board’s view is that negligence has indeed to be linked to the infringement and to establish this negligence, all the circumstances<sup>283</sup> and, therefore, facts that are relevant for example to understand why an infringement took place are to be taken into consideration.

### **Assessment of negligence in the present case**

320. Regarding the assessment of negligence related to the lack of systematic use of the 2015 CB Methodology, the Board notes the following.

321. First, the Board has to consider all the relevant facts and circumstances related to the infringement to establish whether it was committed negligently. In particular, the Board considers that what happened during the adoption of the 2015 CB Methodology and the way this methodology has been drafted are, without a doubt, crucial elements to take into consideration to assess whether the PSI has been negligent in using the 2015 CB Methodology in a non-systematic way.

322. Regarding the adoption of the 2015 CB Methodology, the Board notes the following:

323. The PSI adopted the 2015 CB Methodology according to which a cover pool assessment should be conducted for all ratings whereas it knew that it would not be in a position to perform it for some of them. This clearly denotes a lack of care from the PSI. For example, during the process leading to the adoption of the 2015 CB Methodology, the PSI was fully aware that the lack of sufficient public information would not allow it to apply

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<sup>281</sup> See paragraph 285 of the decisions of the Board of Appeal in the Appeals of Svenska Handelsbanken AB, Skandinaviska Enskilda Banken AB, Swedbank AB and Nordea Bank Abp against ESMA’s decision in the Nordic Banks case (ref. BoA D 2019 01, BoA D 2019 02, BoA D 2019 03 and BoA D 2019 01), available at [https://eiopa.europa.eu/Publications/Board%20of%20Appeal%20-%2027%20February%202019%20-%20Decisions%202019\\_01\\_02\\_03\\_04%20-%20Final.pdf](https://eiopa.europa.eu/Publications/Board%20of%20Appeal%20-%2027%20February%202019%20-%20Decisions%202019_01_02_03_04%20-%20Final.pdf)

<sup>282</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 57.

<sup>283</sup> See, by analogy, CJEU, Case C-587/01, Belgium v/ Commission, 30 January 2019, para. 79, “negligence attributable to the Kingdom of Belgium (...) had to be established in the light of all the circumstances of the case”.

the CB Methodology in all cases. The PSI indeed indicated that “(...) in light of the small amount of public information for all possible assets in a cover pool, (...) the analysts were aware that at the initial stage of establishing a pool of CB ratings it would not seem appropriate to start with the most complex covered bond structures<sup>284</sup>”. According to the PSI<sup>285</sup>, this was the rationale behind the following statements of the PSI in its presentation in December 2014 about CB criteria: “identify ‘friendly’ Issuers that are willing to share current rating data with us to establish modelling capabilities” and “identify less complex covered bond structures to avoid CBM’s [chief business manager] establishing mandates that currently are too complex for us [...]”<sup>286</sup>.

324. In its Response to the IIO’s initial Statement of Findings, the PSI claimed that “According to the PSI’s understanding of its own methodology, the lack of sufficient data on the cover pools would still have allowed to issue CB ratings of adequate quality if these ratings were fully supported by the fundamental benefits of the regulatory framework. Therefore, the PSI did not adopt a methodology that could not be applied in all foreseen cases (...)”<sup>287</sup>. However, the Board cannot accept this argument. This PSI’s claim is contradicted by the above statements of the PSI, which clearly pointed out at the fact that the PSI was aware that it would have to avoid rating some type of CB under the 2015 CB Methodology. Furthermore, as already stated, the 2015 CB Methodology provided for the analysis of the cover pool for all the issuers, including highly rated issuers. The PSI’s argumentation also leaves out the scenarios where because of the lack of sufficient data on the cover pool, it would not have been in a position to rate CB programmes which were not fully supported by the fundamental benefits of the regulatory framework (the analysis of the legal framework and the resolution regime). In addition, whether the CB ratings issued by the PSI without analysing the cover pool were of adequate quality (as claimed by the PSI) is relevant in the context of the aggravating factor of Annex IV, Point I. 4. of the Regulation but not for the assessment of negligence.

325. Regarding the drafting of the 2015 CB Methodology, the reading of the 2015 CB Methodology leads to the conclusion that the application of the 2015 CB Methodology would imply the conduct of a cover pool assessment for all CB ratings, including highly rated issuers. Nevertheless, some statements in the 2015 CB Methodology were less clear. The presence of unclear statements regarding the type of cover pool analysis to be performed in the 2015 CB Methodology shows, in the IIO’s opinion, a lack of care of the PSI in ensuring that this methodology would be compliant with the relevant legal provisions, in particular regarding its systematic application.

326. This lack of care is all the more striking since during the drafting of the 2015 CB Methodology, some concerns were raised internally by the IRF regarding the fact that some elements of the methodology were vague. For example, the IRF indicated the following: “I

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<sup>284</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 3.

<sup>285</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 3.

<sup>286</sup> Supervisory Report, Exhibit 12, XLII\_20141214\_Covered bond criteria\_Exec summary.pptx, p.8.

<sup>287</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 58.

have not well understood what kind of model do you plan to use for assessing the credit quality of the cover pool<sup>288</sup>". The reply from the lead analysis was "Granularity and type of asset will determine what analytical frameworks we are going to use- for public sector or substitute assets we rather will use a CDO [Collateral Debt Obligation] type approach as concentration and correlation needs to be treated differently. I basically opened up all possibilities that we could encounter in the asset analysis and we will use the most suitable<sup>289</sup>". The IRF then indicated the following: "To summarize it would be helpful that you list the Key Rating Assumptions that you will use in the methodology. On the modeling side, at this stage everything is vague both on credit quality and refinancing risk. Do we plan to publish later more details as well as assessment of the CB framework<sup>290</sup>". Therefore, during the internal consultation before the adoption of the 2015 CB Methodology, it was strongly suggested by the IRF to enhance the transparency of the rating process that would be followed for the issuing of CB ratings. This reinforces the lack of care of the PSI in adopting the 2015 CB Methodology that would not be applied systematically.

327. On that basis, the Board disagrees with the argument of the PSI, which argued, in its Response to the IIO's initial Statement of Findings, that "the IIO has not established a lack of care by the PSI regarding the application of the 2015 CB Methodology. Most of its accusations were not even related to its application but happened at another point in time<sup>291</sup>".

328. The Board acknowledges that the PSI reiterated the main defensive arguments in the written submissions to the Board.

329. The PSI claimed in particular that while the Board refers to the application of the 2015 methodology to establish the infringement of Article 8(3), it considers the drafting and adoption of the methodology as relevant to establish the negligence. The PSI considers this approach as not logical and implicitly uses this argument to demonstrate that Article 8(3) does not cover the moment of the application of the methodology.

330. Contrary to the PSI's claims<sup>292</sup>, the Board agrees with the IIO in considering that the above-mentioned elements about the adoption and the drafting of the 2015 CB Methodology are relevant for the establishment of negligence and show a lack of care of the PSI. Circumstances around the adoption and the drafting of a methodology are elements that play a role, as it is in the present case, to determine whether it was by negligence (or by intent) that a methodology was not used systematically.

331. The Board notes that the lack of care of the PSI when it adopted and drafted the 2015 CB Methodology is relevant to establish a lack of care in ensuring that the 2015 CB

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<sup>288</sup> Supervisory Report, Exhibit 15, XLI\_20150128 KF APT GJ Comments Question on CB Methodology - Summary of methodology to APT, p.6.

<sup>289</sup> Supervisory Report, Exhibit 15, XLI\_20150128 KF APT GJ Comments Question on CB Methodology - Summary of methodology to APT, p.6.

<sup>290</sup> Supervisory Report, Exhibit 15, XLI\_20150128 KF APT GJ Comments Question on CB Methodology - Summary of methodology to APT, p.4.

<sup>291</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 59.

<sup>292</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 58.

Methodology was applied systematically in the formulation of all the CB ratings issued under that methodology. On this basis, the Board finds that the negligence in the moment of the application of the 2015 CB Methodology constitutes the necessary consequence, due to a cascade effect, of the lack of care of the PSI in the process of drafting and adopting the Methodology.

332. Second, the Board notes that the PSI did not contact ESMA in advance to check whether there would be reasons (such as the lack of public information or the fact that a CB programme could already achieve an AAA rating based on the fundamental analysis) which could be considered as objective reasons to diverge from the systematic application of the 2015 CB Methodology. In particular, the Board notes that there were some discussions between the PSI and ESMA's Supervision Department in March 2015 to discuss (among others) the analysis that was going to be conducted by the PSI under the 2015 CB Methodology<sup>293</sup>. According to the minutes of this call prepared by the PSI, there were discussions between ESMA and the PSI regarding models and the PSI indicated that "We highlighted the diversity of eligible cover assets, multiple number of jurisdictions that all need to be assessed individually. Further we highlighted the importance of the cash flow analysis. All of the former cannot be reliably assessed from a rating agency perspective due to the lack of detailed public information which prompted us to only provide our conceptual approach<sup>294</sup>". The PSI mentioned the lack of detailed public information and was thus clearly aware of missing information which would be needed to perform its cover pool assessment but, during and despite these contacts, the PSI did not raise any questions to ESMA regarding whether and under which circumstances deviations in the application of the 2015 CB Methodology could be compliant with the Regulation. In line with the CJEU jurisprudence, the fact that an entity did not contact its regulator to clarify doubts about its obligations is an element to take into consideration for establishing a negligent behaviour<sup>295</sup>.

333. Furthermore, there is no evidence in the file of an assessment by the PSI of what could be considered as an "objective reason" (for the purposes of the CRA Regulation) for diverging from the systematic use of a methodology. On the contrary, when asked by the IIO whether it could provide documentation showing such an assessment, the PSI replied that it "(...) did not carry out an assessment of what could be considered as an objective reason for diverging from the systematic use of the methodology<sup>296</sup>".

334. In its Response to the IIO's initial Statement of Findings, the PSI argues that "(...) there can be no documented assessment of any discussion regarding an "objective reason" for

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<sup>293</sup> Supervisory Report, Exhibit 88, XXX\_1144\_20150310\_Memo conf call ESMA scope validation covered bond methodology. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 4.

<sup>294</sup> Supervisory Report, Exhibit 88, XXX\_1144\_20150310\_Memo conf call ESMA scope validation covered bond methodology, p.1.

<sup>295</sup> See General Court, *Marine Harvest ASSA v. Commission*, case T-704/14, 26 October 2017, para. 256: "It is also appropriate to take into consideration the fact that the applicant could have consulted the Commission on the question of the interpretation of Article 7(2) of Regulation No 139/2004. If it is in any doubt as to its obligations under Regulation No 139/2004, the appropriate course of conduct for an undertaking is to contact the Commission (...)".

<sup>296</sup> Exhibit 14, PSI's Response to the IIO's Second RFI, Question 26.



divergence, because from the PSI's point of view, the issued ratings fully complied with the 2015 CB Methodology (...)<sup>297</sup>".

335. On the contrary, the Board acknowledges that the PSI's internal discussions (for example, to "identify less complex covered bond structures to avoid CBM's [chief business manager] establishing mandates that currently are too complex for us [...] <sup>298</sup>") as well as the fact that the relevant press releases about the rating actions issued under the 2015 CB Methodology for which no cover pool assessment was conducted did contain a statement about this lack of cover pool analysis<sup>299</sup>. A diligent professional firm in the financial services sector subject to a high standard of care would not have had such discussions and issued such statements without having properly discussed, reflected and undertaken an assessment about the systematic use of the 2015 CB Methodology and the "objective reasons" for divergence.

336. In line with the high standard of care expected from professional firms in the financial services sector such as CRAs, the Board agrees with the IIO and is of the view that where doubts exist as to the application of provisions whose non-compliance may result in a sanction decision, the onus is on the CRA to seek clarifications in order to ensure that it does not infringe the Regulation<sup>300</sup>. Therefore, before formulating ratings that were not in line with the 2015 CB Methodology, the PSI should have carefully considered whether this could be justified by the existence of "objective reasons".

337. Third, under the 2015 CB Methodology, the cover pool analysis was said to provide additional security and stability to the rating<sup>301</sup> and, therefore, the analysis was aimed, not only at assessing the pool's current risk exposure, but "to provide guidance on drivers for potential rating migration <sup>302</sup>". However, even in those cases where there was no rating buffer, the PSI did not perform a cover pool analysis. For instance, in the press release of the ratings of Danske Bank's covered bonds of 22 September 2015, it is stated that "A negative development of the issuer rating or the outlook could impact the rating of the covered bonds if the additional benefit the cover pool analysis – which could provide an additional credit support of up to three notches - is not taken into account. Only based on

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<sup>297</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 58.

<sup>298</sup> Supervisory Report, Exhibit 12, XLII\_20141214\_Covered bond criteria\_Exec summary.pptx, p.8.

<sup>299</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p.1; Supervisory Report, Exhibit 18, I\_20150922\_BNP Paribas\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 19, I\_20150922\_BPCE SA\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 20, I\_20150922\_Credit Agricole\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 22, I\_20150922\_Societe General\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 4, I\_20150922\_Commerzbank\_Press release\_Initial rating, p.2; Supervisory Report, Exhibit 73, Deutsche Bank's mortgage covered bonds press release, p.2; Supervisory Report, Exhibit 17, I\_20150922\_Banco Santander\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 16, I\_20150922\_BBVA\_Press release\_Initial rating p.3; Supervisory Report, Exhibit 23, I\_20151126\_Nordea Hypotek\_Press release\_Initial rating, pp. 2 and 3; Supervisory Report, Exhibit 24, I\_20151126\_Stadshypotek\_Press release\_Initial rating, p.3; Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, pp. 2 and 3.

<sup>300</sup> See CJEU, Firma Sohl & Sohlke, case C-48/98, 11 November 1999, para. 58: "As regards the care taken by the trader, it must be noted that, where doubts exist as to the exact application of the provisions non-compliance with which may result in a customs debt being incurred, the onus is on the trader to make inquiries and seek all possible clarification to ensure that he does not infringe those provisions".

<sup>301</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, pp. 4 and 5.

<sup>302</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.



the fundamental supporting factors there is no rating buffer available<sup>303</sup>. The PSI nevertheless decided not to perform a cover pool analysis<sup>304</sup>. The same is true with respect to the ratings of Swedbank Mortgage AB's covered bonds of 26 November 2015<sup>305</sup>.

338. In its Response to the IIO's initial Statement of Findings, the PSI held that "(...) a cover pool assessment might have stabilised the rating outlook. But the lack of it cannot establish a lack of care regarding the systematic application of the 2015 CB Methodology" because "(...) the lack of the cover pool assessment had no consequence for the CB rating itself<sup>306</sup>".

339. The Board disagrees with the PSI. While the cover pool might also have an impact on the rating outlook (positive, negative or stable) of the CB ratings issued by the PSI, its analysis under the 2015 CB Methodology was part of the rating assessment of the CB programmes<sup>307</sup>. As such, the objective of the cover pool analysis was, among others, to provide information "(...) on how specific features of the covered bond structure (...) may affect the probability of default and the loss given default (...) <sup>308</sup>", "(...) on the likely rating sensitivity resulting from it<sup>309</sup>" and to establish "(...) rating-contingent breakeven levels of overcollateralisation that reflect [PSI's] assessment of expected loss that a cover bond may incur under stressed scenarios (...) <sup>310</sup>". In the Board's view, the lack of care of the PSI in committing the infringement of not systematically using the 2015 CB Methodology is therefore all the more striking for those ratings where there was no rating buffer available.

340. Fourth, the fact that the 2015 CB Methodology was not applied in a systematic way should have been detected by a professional firm in the financial services sector subject to stringent regulatory requirements and taking special care in assessing the risks that its acts or omissions entail. For example, following the ratings of 22 September 2015, it was noticed that these ratings did not comprise an assessment of the cover pool and a complaint was sent to ESMA<sup>311</sup>.

341. Moreover, the PSI has reiterated, in the written submissions to the Board, the issue regarding the 'common market understanding', that is not proven and, in any case, does not constitute a justification of an incorrect behaviour nor an exclusion of the negligence.

<sup>303</sup> Supervisory Report, Exhibit 21\_I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p.2.

<sup>304</sup> Supervisory Report, Exhibit 21, I\_20150922\_Danske Bank AS\_Press release\_Initial rating, p. 2: "For the unsolicited ratings we have not analysed the cover pools. Both cover pools exhibit differences in credit quality, cash flow structure and protection levels provided (overcollateralisation). These can impact the assessment and potential additional credit differentiation from the rating analysis of the cover pool which could support an additional credit differentiation of up to three additional notches".

<sup>305</sup> Supervisory Report, Exhibit 25, I\_20151126\_Swedbank Mortgage\_Press release\_Initial rating, pp. 2-3: "A negative development in Swedbank's ICSR (Scope's analytical anchor for rating Swedbank Mortgages AB's covered bonds) could also impact the ratings if the additional benefit of the cover pool analysis, which could provide extra credit support of up to three notches, is not taken into account. Only based on the fundamental supporting factors, there is no rating "buffer" available" and "For the unsolicited ratings, Scope did not analyse the cover pools' credit quality, cash flow structure, potential counterparty risk and whether protection levels provided (overcollateralization) could support an additional credit differentiation of up to three extra notches".

<sup>306</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 58.

<sup>307</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond Rating methodology, p. 17: "the covered bond rating methodology rests on two analytical building blocks (...) the second is the cover pool analysis".

<sup>308</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond Rating methodology, p. 9.

<sup>309</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond Rating methodology, p. 9.

<sup>310</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond Rating methodology, p. 9.

<sup>311</sup> Supervisory Report, Exhibit 28, 20170621 Complaint shared with Scope.

342. To conclude, overall, the above elements denote a lack of care by the PSI to ensure the systematic use of the 2015 CB Methodology in accordance with the relevant provision of the Regulation.

343. As a professional firm in the financial services sector subject to stringent regulatory requirements, the PSI is required to take special care in assessing the risks that its acts or omissions entail, and has failed to take that care; and as result of that failure, it has not foreseen the consequences of its acts or omissions, including particularly its infringement of the Regulation, in circumstances when a person in such a position who is normally informed and sufficiently attentive could not have failed to foresee those consequences.

344. Therefore, it is considered that the PSI has been negligent when committing the infringement of Point 43 of Section I of Annex III of the Regulation concerning the systematic application of the 2015 CB Methodology.

## **Fine**

### **Determination of the basic amount**

345. Article 36a of the Regulation provides in paragraph 2 as follows:

“2. The basic amount of the fines referred to in paragraph 1 shall be included within the following limits:

(a) for the infringements referred to in points 1 to 5, 11 to 15, 19, 20, 23, 26a to 26d, 28, 30, 32, 33, 35, 41, 43, 50, 51 and 55 to 62 of Section I of Annex III, the fines shall amount to at least EUR 500 000 and shall not exceed EUR 750 000; (...)

In order to decide whether the basic amount of the fines should be set at the lower, the middle or the higher end of the limits set out in the first subparagraph, ESMA shall have regard to the annual turnover in the preceding business year of the credit rating agency concerned. The basic amount shall be at the lower end of the limit for credit rating agencies whose annual turnover is below EUR 10 million, the middle of the limit for the credit rating agencies whose annual turnover is between EUR 10 and 50 million and the higher end of the limit for the credit rating agencies whose annual turnover is higher than EUR 50 million”.

346. It has been established that the PSI committed the infringement set out at Point 43 of Section I of Annex III of the Regulation by not having applied (until July 2016) the 2015 CB Methodology in a systematic way.

347. To determine the basic amount of the fine, the Board has regard to the PSI's annual turnover in the preceding business year. In 2015, the PSI's total turnover was EUR 4 351 165 and its turnover for credit rating services amounted to EUR 2 259 299<sup>312</sup>.

348. Thus, the basic amount of the fine for the infringement listed in Point 43 of Section I of Annex III of the Regulation is set at the lower end of the limit of the fine set out in Article 36a(2)(a) of the Regulation and shall amount to at least EUR 500 000.

### **Aggravating factors**

349. Annex IV of the Regulation lists the aggravating factors to be taken into consideration for the adjustment of the fine. Their application to the present case is assessed below.

Annex IV, Point I. 1. If the infringement has been committed repeatedly, for every time it has been repeated, an additional coefficient of 1,1 shall apply.

350. Based on the information in the file, the Board considers that the infringement listed in Point 43 of Section I of Annex III of the Regulation regarding the lack of systematic application of the CB Methodology was committed only in relation to the 2015 CB Methodology.

351. As a result, this aggravating factor does not apply.

Annex IV, Point I. 2. If the infringement has been committed for more than six months, a coefficient of 1,5 shall apply.

352. It has to be assessed and established for how long the infringement was committed, or more precisely whether it lasted more than six months, which is sufficient to decide whether the aggravating factor of Annex IV, Point I. 2. of the Regulation applies. In this respect, the Board notes that the PSI submitted detailed comments on the duration of the infringement. In its Response to the IIO's initial Statement of Findings, the PSI stated that "(...) the IIO has not proved a duration of more than six months<sup>313</sup>" because in particular, "(...) the IIO does not provide any evidence of a lack of systematic application of the 2015 CB Methodology for the formulation of credit ratings after November 2015<sup>314</sup>", "the PSI did not apply it in an allegedly unsystematic way throughout the whole period of the 2015 CB Methodology<sup>315</sup>" and "since the alleged infringement results from the alleged unsystematic application of the 2015 CB Methodology for the formulation of credit ratings, it is necessary to consider the exact dates (i.e. 22 September 2015 and 26 November 2015) of these formulations (...) <sup>316</sup>".

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<sup>312</sup> Exhibit 76, Transparency\_Report\_2015, p. 11. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 1.

<sup>313</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 62.

<sup>314</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 64.

<sup>315</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 65.

<sup>316</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 66.

353. The Board disagrees with this very narrow reading of the duration of the infringement. In particular, the Board considers that a reconstruction of the infringement focussing exclusively on the two exact issuances dates would completely ignore the fact that ratings issued in September and November 2015 continued to be relied upon after these dates, while they were diverging from the methodology (until July 2016, when the methodology was revised). A different reading would be contrary to the rationale behind the CRA Regulation (in fact, the outstanding ratings are supposed to have been issued in compliance with the methodology applicable at the time of the issuance).

354. It has been shown that the CB 2015 Methodology was not used/applied systematically from 22 September 2015 (date of the first issuance not compliant with the requirements of the 2015 CB Methodology) until its drafting was changed on 22 July 2016, with the adoption of the 2016 CB Methodology.

355. As a result, the Board is of the view that the infringement lasted for more than six months and that the aggravating factor applies.

Annex IV, Point I. 3. If the infringement has revealed systemic weaknesses in the organisation of the credit rating agency, in particular in its procedures, management systems or internal controls, a coefficient of 2,2 shall apply.

356. The Board notes that the Regulation does not provide guidance on what constitutes “systemic weaknesses in the organisation of the credit rating agency”. However, based on the wording of the terms used, not all weaknesses in the procedures, management systems or the internal controls will necessarily constitute “systemic weaknesses in the organisation of a CRA”.

357. In the file, there is insufficient indication of systemic weaknesses in the organisation of the PSI, in particular in its procedures, management systems or internal controls.

358. This aggravating factor is thus not applicable.

Annex IV, Point I. 4. If the infringement has had a negative impact on the quality of the ratings rated by the credit rating agency concerned, a coefficient of 1,5 shall apply.

359. Evidence of a negative impact on the ratings could for example be inferred from evidence of deviations of ratings between the ratings that were issued by the PSI and the ratings that would have been issued if there would have been no infringement of Point 43 of Section I of Annex III of the Regulation by the PSI, if these deviations could not be explained by other reasons. In particular, the nature of the infringement which relates to the characteristics of the CB Methodology in terms of its systematic use could indeed imply a negative impact on the quality of the ratings.

360. However, in the present case, there is no evidence in the file that would support a demonstration of a negative impact on the quality of the CB ratings issued by the PSI.

361. It should also be noted that the PSI indicated the following: “the rating actions that were issued under the 2015 CB methodology would not have been any different in terms of the level of the assigned ratings if Scope would have conducted a CP analysis<sup>317</sup>”.

362. On that basis, it is not established in the present case that the infringement of Point 43 of Section I of Annex III of the Regulation committed by the PSI had a negative impact on the quality of the ratings.

363. The aggravating factor is, therefore, not applicable.

Annex IV, Point I. 5. If the infringement has been committed intentionally, a coefficient of 2 shall apply.

364. This aggravating factor is not applicable because, as explained above in Section 8.1.2 of this Statement of Findings, there is no evidence that the infringement by the PSI of Point 43 of Section I of Annex III of the Regulation has been committed intentionally.

Annex IV, Point I. 6. If no remedial action has been taken since the breach has been identified, a coefficient of 1,7 shall apply.

365. Substantial changes were included in the 2016 CB Methodology regarding the role of an assessment of the cover pool. In particular, the reference made in the 2015 CB Methodology to the necessity to perform a thorough analysis of the cover pool for all rated covered bonds was removed from the 2016 CB Methodology<sup>318</sup>. The 2016 CB Methodology also provided for a simplified cover pool analysis<sup>319</sup> in those cases where, based on the legal framework and the resolution regime, an AAA rating could already be achieved and / or where only insufficient information on the covered bond structure was available.

366. In addition, in practice, the PSI conducted an analysis of the cover pool for the ratings issued under the 2016<sup>320</sup> CB Methodology.

367. Therefore, the Board considers that remedial actions have been taken since the breach has been identified and this aggravating factor is thus not applicable.

368. As an additional point, the Board acknowledges the following: The PSI indicated that “Discussions between IRF, the analytic team and senior management on ways to fully address the points raised by the ESMA CB investigation on the cover pool analysis in the

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<sup>317</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 34.

<sup>318</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), pp .3 and 9.

<sup>319</sup> Exhibit 48, Comparative version of CB rating methodologies 2015 and 2016 (produced by the IIO), pp. 28 and 29.

<sup>320</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 16.

2018 review of the CB methodology have been initiated<sup>321</sup>. In particular, in the minutes of a meeting which took place on 18 April 2018<sup>322</sup>, it is noted that the analysts proposed changes related to "(...) clarifications on the general framework and on the analysis performed on the cover pool" and that the IRF commented "Although no actual methodology content is to be modified, the methodology needs clarification around the light vs full cover pool analysis, in light of the ESMA CB investigation". In the minutes of a meeting that took place on 15 May 2018<sup>323</sup>, it is noted that the lead analyst will send an updated version of the CB Methodology that will "Develop when limited / light to be applied vs full analysis cover pool analysis". Therefore, the Board notes that the PSI is still further trying to define precisely how the assessment of the cover pool is to take place under the CB Methodology, which would limit risks of a non-systematic use of the CB Methodology.

Annex IV, Point I. 7. If the credit rating agency's senior management has not cooperated with ESMA in carrying out its investigations, a coefficient of 1,5 shall apply.

369. The Board considers that there is no evidence that the PSI (including their senior management<sup>324</sup>) has not cooperated with her during her investigation. Similarly, there is no sign in the file of lack of cooperation of the PSI at the stage of the investigation by ESMA's Supervision Department.

370. Therefore, the aggravating factor relating to a lack of cooperation is not applicable.

### **Mitigating factors**

371. Annex IV of the Regulation lists the mitigating factors to be taken into consideration for the adjustment of the fine. Their application to the present case is assessed below:

Annex IV, Point II. 1. If the infringement relates to a breach listed in Section II or III of Annex III and has been committed for fewer than 10 working days, a coefficient of 0,9 shall apply.

372. This mitigating factor is not applicable; the infringement at Point 43 is listed in Section I of Annex III of the Regulation and not in Section II or III as required by this provision.

Annex IV, Point II. 2. If the credit rating agency's senior management can demonstrate that they have taken all the necessary measures to prevent the infringement, a coefficient of 0,7 shall apply.

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<sup>321</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 33.

<sup>322</sup> Exhibit 77, PSI's Response to the IIO's First RFI, Document 83, Minutes – call meetings – CVB 2018 review. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 33.

<sup>323</sup> Exhibit 77, PSI's Response to the IIO's First RFI, Document 83, Minutes – call meetings – CVB 2018 review. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 33.

<sup>324</sup> The IIO's RFIs were sent to, and the responses were received from, the PSI's contact person as designated by the PSI's legal representative.



373. The Board considers that in her RFI, the IIO requested the PSI to provide any documentation showing specifically the measures taken by the PSI's senior management to prevent the infringement. The PSI provided information and documentation<sup>325</sup>.

374. This documentation is relevant to understand the framework within which the breach took place as well as the recent measures taken by the PSI. However, the Board considers that it does not establish that the PSI's senior management has taken all the necessary measures to prevent the infringement. More generally, the Board did not find evidence in the file that the PSI's senior management has taken all the necessary measures to prevent the infringement of Point 43 of Section I of Annex III of the Regulation regarding the lack of systematic use of the 2015 CB Methodology.

375. In its Response to the IIO's initial Statement of Findings, the PSI indicated that "In 2015, the PSI was still of a size that allowed senior analytical management to be directly involved in the application of the 2015 CB Methodology<sup>326</sup>" and "by establishing a responsible rating committee with considerable experience and diverse backgrounds, senior management took further measures to ensure the highest quality for the rating process<sup>327</sup>".

376. However, these comments do not change the Board's conclusion. The involvement of senior management in the application of the 2015 CB Methodology cannot be seen as the senior management having taken "all the necessary measures to prevent the infringement". On the contrary, in Board's view, this shows that the infringement also involved members of the PSI's senior management.

377. This mitigating factor is thus not applicable.

Annex IV, Point II. 3. If the credit rating agency has brought quickly, effectively and completely the infringement to ESMA's attention, a coefficient of 0,4 shall apply.

378. The Board notes that in its Response to the IIO's initial Statement of Findings, the PSI argued that "(...) it seems sufficient for the mitigating factor that a CRA shares quickly, effectively and completely all relevant information that enable ESMA to conduct its own legal assessment<sup>328</sup>" and "(...) it does not seem necessary that these facts are accompanied by a legal assessment according to which the enclosed facts constitute an infringement<sup>329</sup>".

379. On this basis, the PSI considered that it brought all relevant facts quickly, effectively and completely to ESMA's attention because "The lack of a cover pool assessment for the CB ratings in September and November 2015 was made public in the press releases. Additionally, these press releases were distributed by e-mail. In 2015, at least one member

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<sup>325</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 33.

<sup>326</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 69.

<sup>327</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 70.

<sup>328</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 75.

<sup>329</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, para. 75.

of ESMA Staff (...) was on the relevant mailing list and, therefore, received all necessary information directly by e-mail in the very moment the ratings were published<sup>330</sup>”.

380. The Board acknowledges that the PSI reiterated the same argument in the written submissions to the Board. However, the Board agrees with the IIO and rejects this interpretation of the PSI.

381. The Board believes that the wording of Annex IV, Section II, Point 3 is unequivocal. To be able to benefit from the application of this mitigating factor, a CRA has to bring quickly, effectively and completely the infringement to ESMA’s attention and not just to make public some information on its rating activities that is then made available to ESMA. In addition, to benefit from a mitigating factor, a CRA has to go beyond its legal obligations under the Regulation (including the ones regarding the disclosure to the public of its credit ratings). Moreover, these press releases did not at all point to an infringement (or at least an incident / concern) and cannot be considered as a notification to ESMA in an effective and complete manner. The fact that one member of ESMA Staff, who is not even in the team in charge of CRA supervision, was on the mailing list to which these press releases were distributed is also clearly insufficient because it was not addressed to ESMA as its supervisor.

382. The Board also notes that during the discussions between the PSI and ESMA’s Supervision Department in March 2015<sup>331</sup> and in May 2016<sup>332</sup>, the PSI did not inform ESMA about the infringement. In particular, the discussions in March 2015 took place before the adoption of the 2015 CB Methodology (i.e. before the infringement) and the discussions held in May 2016 took place after ESMA had started its investigation and had already received a complaint regarding the application of the 2015 CB Methodology.

383. The Board therefore finds that this mitigating factor is not applicable because the PSI has never brought the infringement of Point 43 of Section I of Annex III to ESMA’s attention. In fact, the infringement was revealed by ESMA’s investigation.

Annex IV, Point II. 4. If the credit rating agency has voluntarily taken measures to ensure that similar infringement cannot be committed in the future, a coefficient of 0,6 shall apply.

384. As explained above regarding the aggravating factor set by Annex IV, Point I. 6. of the Regulation, the Board considers that a number of remedial actions have been taken. In the Board’s opinion, these remedial actions should ensure that similar infringement cannot be committed in the future. The Board turns to the assessment whether these measures were taken voluntarily. If that was the case, it would imply that the mitigating factor provided by Annex IV, Point II.4. of the Regulation would be applicable.

385. The Board notes that there is no definition of what “voluntarily” (“*de son plein gré*” in the French version of the Regulation) precisely means within the context of this mitigating

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<sup>330</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, para. 76.

<sup>331</sup> Supervisory Report, Exhibit 88, “1144\_20150310\_Memo conf call ESMA scope validation covered bond methodology”.

<sup>332</sup> See Exhibit 68, PSI’s Response to the IIO’s Third RFI, Document “20160504 Memo call ESMA Scope Covered bond Rating action Sept 2015”. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 4.

factor. On the one hand, the fact that a CRA has voluntarily taken measures should be distinguished from the fact that the CRA has taken them spontaneously without any solicitation from its supervisor. On the other hand, it is obvious that when there is a specific obligation to take these measures, it can no longer be considered that the measures are taken voluntarily. The situation is to a certain extent less clear-cut when the CRA takes measures only after a number of requests and interactions with its supervisor aiming at ensuring that the said measures are implemented by the CRA.

386. In the present case, the Board notes the following: First, at the date of implementation of the measures, the PSI was not under a specific obligation (other than its obligation to comply with the Regulation) to take these measures; for example, there was no decision from ESMA ordering the PSI to put an end to its practices. Second, some of the measures might have been triggered following interactions with ESMA's staff. However, the decision of whether or not to take these measures was within the PSI's remit.

387. Therefore, the Board considers that the PSI has voluntarily taken measures to ensure that similar infringement cannot be committed in the future. The mitigating factor is thus applicable.

#### **Determination of the adjusted fine**

388. In accordance with Article 36a(3) of the Regulation, taking into account the applicable aggravating and mitigating factors, the basic amount of EUR 500 000 must be adjusted as follows:

389. The difference between the basic amount and the amount resulting from the application of each individual coefficient linked to the aggravating factor set out in Annex IV, Point I.2, and the mitigating factor set out in Annex IV, Point II.4 is added to the basic amount in the case of the aggravating factor and subtracted from the basic amount in the case of the mitigating factor:

#### Aggravating factor set out in Annex IV, Point I.2:

$$\text{EUR } 500\,000 \times 1.5 = \text{EUR } 750\,000$$

$$\text{EUR } 750\,000 - \text{EUR } 500\,000 = \text{EUR } 250\,000$$

#### Mitigating factor set out in Annex IV, Point II.4:

$$\text{EUR } 500\,000 \times 0.6 = \text{EUR } 300\,000$$

$$\text{EUR } 500\,000 - \text{EUR } 300\,000 = \text{EUR } 200\,000$$

#### Adjusted fine taking into account applicable aggravating and mitigating factors:

$$\text{EUR } 500\,000 + \text{EUR } 250\,000 - \text{EUR } 200\,000 = \text{EUR } 550\,000$$

390. Consequently, following the adjustment by taking into account the applicable aggravating and mitigating factors, the amount of the fine to be imposed on the PSI would amount to EUR 550 000.

391. Article 36a(4) of the Regulation provides that “Notwithstanding paragraphs 2 and 3 [of Article 36a], the fine shall not exceed 20% of the annual turnover of the credit rating agency concerned in the preceding business year”.

392. In 2015, the PSI had a total turnover of EUR 4 351 165<sup>333</sup>. The cap of 20% of the PSI’s turnover for 2015 thus corresponds to a fine of EUR 870 233. It follows that the amount of the fine to be imposed on the PSI does not exceed that sum. Therefore, it is not necessary to adjust the fine in light of the 20% turnover cap.

393. Finally, Article 36a(4) of the Regulation also provides that “where the credit rating agency has directly or indirectly benefitted financially from the infringement, the fine shall be at least equal to that financial benefit”.

394. In this respect, in response to a request to provide the revenues received by the PSI for having issued CB ratings from 2015 to 2017, the PSI indicated that its revenues for having issued CB ratings (both public and private) amounted to EUR 155 000 under the 2015 CB Methodology, EUR 302 500 under the 2016 CB Methodology and EUR 302 500 under the 2017 CB Methodology<sup>334</sup>.

395. Without the need to decide whether the revenues under the 2015 CB Methodology are an indirect benefit of the infringement, it suffices to note that the fine is higher than the revenues received by the PSI.

### **Supervisory measure**

396. Regard must be paid to Article 24, paragraphs 1 and 2, of the Regulation.

397. Given the factual findings in the present case, only the supervisory measure set out in Article 24(1)(e) of the Regulation may be considered appropriate with regard to the nature and the seriousness of the infringement.

398. It must thus be held that the issue of a public notice would be the only proportionate supervisory action.

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<sup>333</sup> Exhibit 76, Transparency\_Report\_2015, p. 11. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 1.

<sup>334</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 38.

## **Findings of the Board with regard to the infringements at Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation concerning material changes to methodologies**

399. This section of the Statement of Findings analyses whether the PSI breached the following requirements concerning material changes to methodologies:

- “[a] credit rating agency that intends to make a material change to, or use, new rating methodologies, models or key rating assumptions which could have an impact on a credit rating shall publish the proposed material changes or proposed new rating methodologies on its website inviting stakeholders to submit comments for a period of one month together with a detailed explanation of the reasons for and the implications of the proposed material changes or proposed new rating methodologies” (Article 8(5a) of the Regulation).
- “(...) the credit rating agency shall notify ESMA of the intended material changes to the rating methodologies, models or key rating assumptions or the proposed new rating methodologies, models or key rating assumptions when the credit rating agency publishes the proposed changes or proposed new rating methodologies on its website in accordance with Article 8(5a). After the expiry of the consultation period, the credit rating agency shall notify ESMA of any changes due to the consultation” (third subparagraph of Article 14(3) of the Regulation).
- “[w]here rating methodologies, models or key rating assumptions used in credit rating activities are changed in accordance with Article 14(3), a credit rating agency shall: (...) (aa) immediately inform ESMA and publish on its website the results of the consultation and the new rating methodologies together with a detailed explanation thereof and their date of application” (Article 8(6) of the Regulation).

400. If these requirements are not met, this would constitute the infringements set out at Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation.

### **Board’s assessment**

401. As a preliminary remark, it should be noted that the above requirements regarding material changes to a methodology apply also when a new methodology is adopted. Regarding the adoption of the 2015 CB Methodology, the Board notes the following: the

draft methodology was published on the PSI's website<sup>335</sup>; there was a call for comments<sup>336</sup> and a publication of the results of the consultation<sup>337</sup>; ESMA was notified about the proposed methodology<sup>338</sup> and after the consultation<sup>339</sup>.

402. The issue at stake is whether the PSI complied with the relevant requirements regarding the changes that were introduced to its CB Methodology in 2016.

403. Those requirements apply only if these changes were to be considered as material changes<sup>340</sup>. In this respect, the Board notes the following:

#### **Concerning the changes to the 2015 CB Methodology**

404. A comparison of the 2016 CB Methodology with the 2015 CB Methodology clearly shows the changes that were introduced to the 2015 CB Methodology<sup>341</sup>. The main changes in the 2016 CB Methodology relate to the cover pool analysis.

405. The Board notes that in its Supervisory Report, ESMA's Supervision Department considered those changes as material and referred to Question 7 of ESMA's Q&A<sup>342</sup>. Indeed, Answer 7 of this Q&A gives some indication on when a change to a methodology should be considered as material. It notes that this would be the case for changes that "could have an impact on a credit rating" and also provides a non-exhaustive list of examples, such as a change in the key criteria used, a change in the key rating assumptions, a change in the respective weight of the qualitative and quantitative factors, etc.

406. On the contrary, in its Comments on the Supervisory Report, the PSI challenged ESMA's Supervision Department's assessment of a number of changes introduced in 2016 as material. It explained that these changes were only clarifications<sup>343</sup> to the 2015 CB Methodology.

407. More generally, according to the PSI, the changes to the 2015 CB Methodology were not material. In its Comments on the Supervisory Report, the PSI indicated that "In terms of the substance of the 2016 adjustments to the CB methodology, Scope notes that these were not aiming at changing the analytical approach or the rating criteria for rating covered bonds and had no impact on any of Scope's outstanding CB ratings. These adjustments

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<sup>335</sup> Supervisory Report, Exhibit 95, XII\_20150212\_Scope press release covered bond rating methodology\_Call for comments.

<sup>336</sup> Supervisory Report, Exhibit 96, XIII\_20150212\_Scope Ratings\_Covered bond rating methodology\_Call for comments.

<sup>337</sup> Supervisory Report, Exhibit 107, XVIII\_Covered bond call for comment summary report.

<sup>338</sup> Supervisory Report, Exhibit 93, X\_20150211 APT to ESMA Notification of Proposed Methodology for Rating Covered Bonds.

<sup>339</sup> Exhibit 40, PSI's Response to the IIO's First RFI, Document 62, RE Final Covered Bond Rating Methodology.

<sup>340</sup> Article 8(5a) and the third subparagraph of Article 14(3) of the Regulation includes an explicit mention to "material changes". There is an indirect reference to "material changes" in Article 8(6) of the Regulation through the expression of "[w]here rating methodologies, models or key rating assumptions used in credit rating activities are changed in accordance with Article 14(3)" of the Regulation.

<sup>341</sup> Exhibit 48, Comparative version of the CB Rating Methodologies 2015 and 2016 (produced by the IIO).

<sup>342</sup> Exhibit 1, ESMA/2018/14 Supervisory Report, paragraphs. 288 and 293 to 295.

<sup>343</sup> See Exhibit 8, PSI's Comments on the Supervisory Report, p.6.



were rather aiming at clarifying some of the - admittedly – unclear or sometimes contradictory wording that was contained in the 2015 version of the CB methodology<sup>344</sup>.

408. The PSI also indicated in its Comments on the Supervisory Report that it took into consideration ESMA's Q&A (Answer 7), compared the changes to the 2015 CB Methodology with the points listed in this Q&A and considered that they were not material<sup>345</sup>.

409. The PSI indicated that "This was obviously based on the assumption that in taking this assessment it would be necessary to conduct this assessment with a view to Scope's existing CB ratings rather than the CB ratings of another CRA or all ratings that do not yet exist but could possible ever exist in that asset class<sup>346</sup>". According to the PSI, "ESMA's supervisory team has a different reading of these requirements and applies the guidance provided in answer 7 of ESMA's Q&A at a level that would look at all credits or transactions in a given asset class that could ever potentially be rated<sup>347</sup>". In this respect, the PSI relies on the fact that Article 8(5a) of the Regulation refers to an "impact on a credit rating" and not to a "potential" or "future" credit rating, and that "credit rating" implies the existence of an "opinion" having been issued. Regarding the reference to "stakeholders" in Article 8(5a) of the Regulation, the PSI considers that they can be either investors who have relied on a specific rating or issuers of an instrument that was rated, which in the PSI's mind indicates that the impact to be assessed must be on existing ratings<sup>348</sup>.

410. The PSI also referred to Article 8(5) of the Regulation which deals with the obligation for CRAs to monitor ratings "where material changes occur that could have an impact on a credit rating". According to the PSI, this almost identical wording as in Article 8(5a) also implies that the impact to be assessed must be on existing ratings<sup>349</sup>. The PSI considers that Article 8(6) and the procedural steps that are indicated therein also support this conclusion<sup>350</sup>.

411. The PSI also mentioned that "Whether changes to a rating methodology are material can only be determined with regards to the aim of this disclosure duty. According to Recital 25 of the CRA Regulation, the disclosure of information on methodologies should enable the users of credit ratings to perform their own due diligence when assessing whether to rely or not on those credit ratings. Therefore, a change has to be seen as material, if it can have an impact on the result of an active credit rating of the CRA that introduces a new version of a methodology. Because, from the view of the users, only a (potential) impact on the result might require a new assessment of reliability of rating<sup>351</sup>".

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<sup>344</sup> See Exhibit 8, PSI's Comments on the Supervisory Report, p.6.

<sup>345</sup> See Exhibit 8, PSI's Comments on the Supervisory Report, p.14.

<sup>346</sup> See Exhibit 8, PSI's Comments on the Supervisory Report, pp. 14 and 15.

<sup>347</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.15.

<sup>348</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.15.

<sup>349</sup> Exhibit 8, PSI's Comments on the Supervisory Report, p.15.

<sup>350</sup> Exhibit 8, PSI's Comments on the Supervisory Report, pp. 15-16.

<sup>351</sup> Exhibit 14, PSI's Response to the IIO's Second RFI, Question 23.

412. Therefore, the PSI considered that “(...) it had correctly assessed the updates of its CB methodology in July 2016 as not being a material change since these updates did not have any direct or indirect impact on its existing CB ratings at that time<sup>352</sup>”. The PSI specified the following: “At the time of the 2016 CB Methodology update most of the CB rated by Scope reached the highest achievable rating based on the fundamental approach. As a consequence, changes made to the cover pool analysis, whether material or not, could not have impact on their rating<sup>353</sup>”. The PSI added that “For those CB ratings that were based on both the fundamental rating drivers and uplift from the CP analysis, Scope assessed whether the updates to its CB methodology would affect the analysis or the level of the assigned ratings and, taking into account the guidance on what constitutes a “material change” that was set out in ESMA’s Q&A, came to the conclusion that this was not the case<sup>354</sup>”. The PSI also gave details about why it considered that the analysis of the covered bond that was conducted for the ratings of Dexia<sup>355</sup> and Bankia<sup>356</sup> would not have been different under the updated CB methodology<sup>357</sup>.
413. In the written submissions to the Board, the PSI reiterated its main arguments and specified that “the assessment of materiality – even though based on a case by case analysis – has to consider the examples [of] Answer 7 of the Q&A (...). In particular, the change can only be regarded as material, if it is similar in its extent and impact to the examples being given in Answer 7 of the Q&A. (...) it cannot be considered irrelevant that the 2015 CB Methodology did not compare to any of the given examples (...). Moreover, the PSI reiterated that “the change to the 2015 CB Methodology did not change the way in which an assessment of the cover pool had to be performed (...)”<sup>358</sup>.
414. On the basis of the IIO’s findings, having assessed the information in the file, the applicable legal provisions and the various arguments raised by the PSI, also in the context of the written submissions to the Board, the opinion of the Board regarding the materiality of the changes to the 2015 CB Methodology is the following.
415. First, the Board notes that there is no definition in the Regulation of a “material change”. The usual meaning of the term “material”, according to the Oxford University Press’ Oxford Dictionaries and the Collins Dictionary of English, refers to “Significant; important” and “of great import or consequence; relevant”, respectively<sup>359</sup>.

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<sup>352</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.16.

<sup>353</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 25.

<sup>354</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p.16.

<sup>355</sup> Exhibit 41, Supervision Department’s Response to the IIO, Document 1, 2g I\_20151126\_Dexia Kommunalbank\_Press release\_Initial rating.

<sup>356</sup> Supervisory Report, Exhibit 75, 20160704 Bankia Spanish MCB Press Release.

<sup>357</sup> Exhibit 8, PSI’s Comments on the Supervisory Report, p. 16-17. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 25.

<sup>358</sup> See written submissions to the Board, p. 29.

<sup>359</sup> See Exhibit 200, Definition of “material”, Oxford Dictionaries, and Exhibit 201, Definition of “material”, Collins English Dictionary.

416. The other linguistic versions of the Regulation refer, for example, to “de façon substantielle” in French, “wesentlichen” in German, “sustancialmente” in Spanish, “materialmente” in Italian and “significativamente” in Portuguese.
417. Furthermore, Answer 7 of the Q&A<sup>360</sup> provides only a non-exhaustive list of examples (as shown by the use of “among others”). Therefore, other changes which are not part of this list could also be qualified as material changes. In the Board’s view, the materiality of a change which would not be amongst the examples listed would thus need to be assessed on a case-by-case basis.
418. Regarding the argument of the PSI that the changes to the methodology did not have in practice an impact on the existing CB ratings, the Board agrees with the IIO and considers that the PSI’s interpretation is too narrow.
419. Article 8(5a) of the Regulation refers to material changes which could have an impact on credit ratings, which means that the changes could potentially have impacted the ratings, but it does not have to be necessarily the case for the changes to be considered as material. Similarly, Answer 7 of the Q&A<sup>361</sup> also does not point at a narrow interpretation of “material changes”. It refers to material changes as changes that “could have an impact on a credit rating”, and not as changes that actually have an impact on the existing ratings. In addition, the requirement of the third subparagraph of Article 14(3) of the Regulation applies in case of “intended material changes to the rating methodologies, models or key rating assumptions” without any precision that these intended material changes should have an impact on the ratings.
420. Moreover, regarding the context of the relevant provisions and the objective pursued through the disclosure obligations around methodologies, the IIO noted Recital 27 of the CRA III Regulation, which stated that “(...) issuers, investors and other interested parties should have the opportunity to comment on any intended change to rating methodologies”, clearly pointing out that contrary to the PSI’s claim, the legislators did not want to follow a narrow interpretation of “change” and of the related disclosure obligations.
421. Regarding the context, it is also interesting to compare the drafting of Article 8(5a) of the Regulation, where the requirement applies in case of “a material change to, or use, new rating methodologies, models or key rating assumptions which could have an impact on a credit rating” with for example other provisions of the Regulation such as Article 8(7) of the Regulation, according to which the relevant publication requirement in case of errors in rating methodologies applies “where errors have an impact on its credit ratings” (i.e. only

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<sup>360</sup> Similarly, in relation to another area of CRA supervision, regarding “material changes to the conditions for registration”, Section 5.12 of the Guidelines on Periodic Reporting (Exhibit 61) also does not point at a narrow interpretation (e.g. use of expressions such as “including but not limited”; “any change that may affect compliance with the requirements of the CRA Regulation”, etc.).

<sup>361</sup> Similarly, in relation to another area of CRA supervision, regarding “material changes to the conditions for registration”, Section 5.12 of the Guidelines on Periodic Reporting (Exhibit 61) also does not point at a narrow interpretation (e.g. use of expressions such as “including but not limited”; “any change that may affect compliance with the requirements of the CRA Regulation”, etc.).

where there is actually an impact on the ratings, not where there could potentially be an impact).

422. In addition, Article 8(5) of the Regulation provides that “A credit rating agency shall monitor credit ratings and review its credit ratings and methodologies on an ongoing basis and at least annually, in particular where material changes occur that could have an impact on a credit rating”. The Board notes that the IIO agreed with the PSI that the drafting in Article 8(5) of the Regulation is interesting for the purposes of this case. However, her conclusions are different: the review requirement applies, by definition, only with respect to existing credit ratings, but there is no need for the material changes to have an actual impact on these existing ratings. On the contrary, a potential impact would be sufficient because one of the objectives of the review is precisely to assess whether there is a need to re-rate. The Board endorses this reading.
423. On that basis, the Board considers that, in the absence of a definition in the Regulation and of an exhaustive list of examples, a case-by-case assessment has to be performed to assess the materiality of changes to an existing methodology. In particular, the Board disagrees with the argument of the PSI according to which a change to a methodology is not material simply because it did not actually have an impact on the existing ratings. In this respect, the focus is not so much on whether the rating is already existing or not, but rather on whether, because of the changes to the methodology, there could be / could have been a potential impact on a rating under this methodology, irrespective of whether this impact actually exists.
424. The Board acknowledges that the IIO agreed with the point made by the PSI that regarding the assessment of the materiality of changes in the methodology of a CRA, the impact to be assessed cannot cover the ratings of other CRAs, because those ratings are issued under different methodologies.
425. The Board also notes that in its Response to the IIO’s initial Statement of Findings, the PSI indicated that “the materiality of a change to the methodology is not (only) defined by the fact whether the change could have an impact on a credit rating. (...) The change of the methodology (i) has to be material and (ii) it could have an impact on a credit rating. Both conditions may overlap in some or even most cases. However, they are not identical, and one condition cannot be interpreted by equalling it with the other condition. Otherwise, the term “material” would have no significance at all<sup>362</sup>”. On this point, the Board notes that the IIO focused on, and assessed in-depth above, the concepts of potential impact / actual impact on existing ratings only because the PSI itself raised the argument that it relied on the fact that no existing rating was impacted by the changes to the 2015 CB Methodology to conclude that these changes were not material. In this regard, the Board agrees with the IIO and is of the view that the mere fact that no existing rating would be impacted cannot per se exclude that these changes are material for the purposes of the Regulation. The nature of these changes has to be assessed on a case-by-case basis to determine whether

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<sup>362</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, p. 28.

they are material. Changes could be material even if no existing rating is impacted and if there could have been only a potential impact.

426. Second, regarding the assessment which was performed by the PSI about the materiality of the changes to the 2015 CB Methodology, the Board acknowledges that in the credit rating memorandum which was prepared for the annual update of the 2015 CB Methodology, it is indicated that “No ratings are impacted as the update primarily adds clarifications, expands on the modelling approach and gives an indication for the cover pool analysis for covered bond ratings primarily based on the fundamental benefits<sup>363</sup>”. This conclusion seems to have been taken by the committee as a whole, including but not exclusively by the review function, and is based on the fact that no ratings are impacted by the update.
427. The main changes to the 2015 CB Methodology are also summarised in the credit rating memorandum<sup>364</sup> which was prepared for the annual update of the 2015 CB Methodology: “i) Clarifications in wordings and clearer structuring (...)” but also “ii) (...) an Appendix on the technical details of the cover pool analysis (...) iii) a clarification on the role of the cover pool analysis if the highest ratings are already supported by results of the fundamental framework analysis. Existing ratings are not impacted by this update”.
428. Therefore, this memorandum clearly states that the updates to the 2015 CB Methodology are not only clarifications in wording (Point i) quoted above) but also concern other types of changes. Once again, the fact that the existing ratings were not actually impacted seems to have been the main element for the PSI to consider that these changes were not material.
429. In the credit rating memorandum which was prepared for the annual update of the 2015 CB Methodology, there is also a section entitled “Remaining Discussion points highlighted by the review function”, which comprises some developments regarding the fact that “cover pool analysis for fundamental support is new” and which in particular assesses the impact of the updated analysis for a number of ratings<sup>365</sup>.
430. Therefore, the Board finds that by relying on the fact that existing ratings were not in practice impacted by the changes introduced in the 2015 CB Methodology despite the significant developments and modifications regarding the cover pool analysis, the PSI incorrectly addressed the issue of whether these changes were material. The mere possibility that ratings under the CB Methodology could have been impacted should have been taken into consideration to assess the materiality of the changes. On this point the

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<sup>363</sup> Exhibit 45, PSI's Response to the IIO's First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.3.

<sup>364</sup> Exhibit 45, PSI's Response to the IIO's First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.3.

<sup>365</sup> Exhibit 45, PSI's Response to the IIO's First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.4.

Board reiterates that the lack of an actual impact is not per se sufficient to exclude the materiality of the changes.

431. Third, the Board agrees with the IIO and considers that the changes to the 2015 CB Methodology are material because they changed the way in which an assessment of the cover pool has to be performed. The following examples are to be considered:

- There is a completely new Appendix which explains how the covered bond risk analysis is conducted<sup>366</sup>.
- The circumstances under which a cover pool analysis is to take place are described in more limitative terms in the 2016 CB Methodology. The sentence which read as “a thorough analysis of the cover pool needs to be performed for all rated covered bonds<sup>367</sup>” is deleted in the 2016 CB Methodology. Conversely, the following sentence is added: “For highly rated issuers active in countries where the fundamental support already allows the highest ratings to be achieved, the cover pool analysis might only be needed to provide comfort on the covered bond’s ratings stability<sup>368</sup>”. The term “detailed” is also deleted in the 2016 CB Methodology regarding the quantitative analysis of the cover pool<sup>369</sup>. Therefore, whereas the drafting of the 2015 CB Methodology provided for a thorough and detailed analysis of the cover pool for all rated covered bonds, the 2016 CB Methodology is much more nuanced regarding the need, level of details and circumstances under which this analysis might take place.
- The 2016 CB Methodology introduces the possibility of a simplified cover pool analysis in case of insufficient available information on the cover pool. This simplified analysis would take place according to a new Appendix IV introduced into the 2016 CB Methodology<sup>370</sup>.

<sup>366</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, pp. 17-21.

<sup>367</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.9.

<sup>368</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, p.4.

<sup>369</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, p.5: the sentence which read in the 2015 CB Methodology as “Scope performs and publishes a detailed quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers” reads as follows in the 2016 CB Methodology: “Scope performs a quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers”. The IIO notes that the reference to highly rated issuers is kept; however, it has to be read in conjunction with the addition of the precision at page 4 of the 2016 CB Methodology that, for highly rated issuers, the cover pool analysis is only a possibility (“might only be needed to provide comfort (...”).

<sup>370</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, p. 23: The completely new Appendix IV of 2016 CB Methodology now provides the following:

“For highly rated issuers that already achieve AAA ratings based on the fundamental credit support, the cover pool analysis primarily seeks to identify whether the cover pool could stabilise the rating in case of an issuer downgrade.

Generally we apply the same principles to the cover pool risk analysis, even when the additional uplift is not needed to support the current rating. When we only have access to publicly available information on the covered bond structure (such as regulatory-required transparency publications or voluntary cover pool information such as the European Covered Bond Council’s Harmonised Transparency Template – HTT), the cover pool analysis might not be able to provide the same rating differentiation as the in-depth asset credit and cash flow risk analyses.

Scope seeks to understand whether under conservative assumptions the full repayment of the covered bonds is highly likely or not. In case our quantitative analysis cannot be fully replicated with available information we seek to understand whether additional information on the bank (e.g. the annual report) or general market data provided by reputable resources (e.g. central bank data) can substitute potential gaps. Alternatively we will substitute the quantitative analysis with a conservative, expert view on the identified risk.



- The 2016 CB Methodology also provides that in case of simplified cover pool analysis, the uplift is limited to 1 notch<sup>371</sup>, compared to the 3 notches in case of non-simplified analysis.

432. As indicated before, the list of examples of material changes provided by Answer 7 of the Q&A is not exhaustive. The Board considers relevant the IIO's view that even though not identical to the examples listed in the Q&A, the changes to the 2015 CB Methodology mentioned above are as relevant as the listed ones in order to qualify as material. For example, limiting the circumstances under which an in-depth cover pool analysis will take place, introducing another type of cover pool analysis (i.e. simplified analysis) and modifying the number of notches that can be obtained is not less material than for example changing a key criterion or changing the weight of a qualitative or quantitative factor (as listed in the Q&A).

433. In its Response to the IIO's initial Statement of Findings, the PSI emphasized that most of the examples given by Answer 7 of the Q&A refer to "key" criteria, "key" variables, "key" rating assumptions, etc<sup>372</sup> and asserted that "(...) the given examples establish a high threshold for a material change". In this respect, it suffices to note once again that the list of examples is non-exhaustive. Furthermore, in terms of materiality, the changes to the 2015 CB Methodology are as relevant as those listed in the Q&A. The Board agrees with the IIO and does not consider relevant the affirmation of the PSI that they "(...) did not compare to any of the given examples (...) <sup>373</sup>". In addition, defining the way, the circumstances and the impact of the analysis of the cover pool is a "key" element in a rating methodology about covered bonds.

434. Also, in relation to Answer 7 of the Q&A, the PSI indicated that "According to Answer 7 of the Q&A, only a change that has an impact on a significant number of credit ratings has to be qualified as material. In a reverse conclusion, a change cannot be regarded as material only because it "could have" an impact on a credit rating (as long as no other reasons justify the materiality)<sup>374</sup>". In this respect: (i) the list of examples in Answer 7 of the Q&A is not exhaustive, (ii) as explained above, the fact there is no actual impact of the changes on existing ratings is not per se sufficient to exclude that the changes would be material (additionally, a change can be qualified as material even though it does not have an impact on a significant number of ratings), and (iii) in the present case the fact that the changes to the 2015 CB methodology are material is based on the above assessment of their nature and is not derived, contrary to the PSI's claim, only from the fact that these changes could have a potential impact. In particular, the PSI's affirmation that "(...) the IIO

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Our methodology generally will constrain the cover pool benefit arising from a simplified analysis by up to one notch on top of the fundamental support. This reduced cover pool uplift also reflects that public information may not allow us to establish an in-depth understanding of the issuer's i) cover pool management strategy (cover pool composition as well as issuance strategy) and ii) ability and willingness to continuously support the covered bonds with overcollateralisation that maintains the highest uplift".

<sup>371</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, p.23.

<sup>372</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 28.

<sup>373</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 29.

<sup>374</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 28.

has only analysed the potential impact of the changes of the methodology (...) <sup>375</sup> is incorrect.

435. Regarding the examples mentioned above, the PSI claimed that they were all only clarifications, for example, because they formalised a practice already conducted by the PSI (even though not explicitly mentioned in the 2015 CB Methodology). In particular, in its Response to the IIO's initial Statement of Findings, the PSI indicated that "The PSI's assessment was based on the fact that it regards all amendments only as clarifications of its 2015 CB Methodology. All changes mentioned by ESMA were seen as clarifications, regardless of whether they were explicitly called "clarifications" or not. The intention of the 2016 CB Methodology was to describe more precisely the methodology which had been used by the PSI before (since July 2015) and which had not fully adequately been described in the 2015 CB Methodology <sup>376</sup>".
436. This PSI's statement contradicts the credit rating memorandum <sup>377</sup> which was specifically prepared at the time for the changes to the 2015 CB Methodology. This argumentation of the PSI also confirms the lack of systematic application of the 2015 CB Methodology, which constitutes a separate infringement. In any event, these changes cannot be seen as mere clarifications. Regarding materiality, as detailed below, the Board bases its conclusion on the nature of the changes which were introduced.
437. For example, regarding the new Appendix which explains how the covered bond risk analysis is conducted, the PSI indicated that it "(...) only records how it [the covered bond risk assessment] was already conducted under the 2015 CB Methodology. (...) the new Appendix only increased the transparency of the rating methodology but did not change the rating methodology itself <sup>378</sup>". On the contrary, having a dedicated appendix which now explains in detail how the covered bond risk analysis is conducted whereas this information was not provided in the previous version of the methodology, is to be considered as a material change.
438. Regarding the fact that the circumstances under which a cover pool analysis is to take place are described in more limitative terms in the 2016 CB Methodology, the PSI indicated that "The description of the circumstances under which a cover pool assessment has to take place only clarifies the PSI's approach" because it considered that "(...) the 2015 CB Methodology already allowed to skip the cover pool assessment if the ratings were already supported by the fundamental benefits of the regulatory framework <sup>379</sup>". As already indicated, the Board finds that a systematic application of the 2015 CB Methodology did not allow the absence of a cover pool analysis. Therefore, identifying in the updated CB

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<sup>375</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 29.

<sup>376</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 29.

<sup>377</sup> Exhibit 45, PSI's Response to the IIO's First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.3.

<sup>378</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 30.

<sup>379</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 30.

Methodology the circumstances under which this analysis would or would not take place is a material change, and not a mere clarification.

439. On the introduction of the possibility of a simplified cover pool analysis, the PSI indicated that “The introduction of the simplified cover pool assessment also did not constitute a change to the 2015 CB Methodology. (...) If it was possible within the 2015 CB Methodology to skip the cover pool assessment, a simplified cover pool assessment was possible all the more within the 2015 CB Methodology<sup>380</sup>”. The Board agrees with the IIO and rejects also this argument of the PSI. Introducing the possibility of a simplified cover pool analysis in a methodology which provided before for the performance of “a thorough analysis of the cover pool<sup>381</sup>” and “a detailed quantitative analysis of the cover pool for programmes from both highly and lowly rated issuers<sup>382</sup>” is without a doubt a material change, and more than a clarification contrary to the PSI’s assertion.
440. On the fact that the uplift is limited to 1 notch in case of a simplified cover pool analysis, the PSI indicated that “The limitation of the uplift to 1 notch compared to the 3 notches in case of non-simplified assessment does not constitute a change. This specification was codified at the time around the 2016 CB methodology adjustment but, as the level of public cover pool information is limited, it reflects a specification that would likely have been applied before (...)”<sup>383</sup>. On this point again, the Board agrees with the IIO and rejects the argument of the PSI. The limitation of the uplift to 1 notch only was not foreseen in the 2015 CB Methodology: the PSI itself admitted that this “would likely have been applied”, i.e. it was clearly not provided in the 2015 CB Methodology and might not even have been applied by the PSI.
441. It is also interesting to note that in the document drafted by the IRF to record in the relevant archive the process of adoption of the 2016 CB Methodology and her involvement in this process, she indicated that “one of the major objective of the 2016 rating methodology was to strengthen the description of the quantitative analysis of the cover pool and to determine the analytical framework to be used by rating committees to decide on the key inputs for the modelling of the cash flow risk analysis. (...)”<sup>384</sup>, which also clearly points to material changes and not simple clarifications as claimed by the PSI.
442. To conclude, having assessed the changes introduced to the 2015 CB Methodology, the Board considers that they are material for the purposes of the Regulation.
443. Finally, the Board notes that in its Response to the IIO’s initial Statement of Findings, the PSI indicated that “(...) attention should be paid to the principle of legal certainty (...). The principle of legal certainty requires that any provision – or, one might add, its interpretation by the competent authority – must be clear and precise so that the persons

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<sup>380</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, p. 30.

<sup>381</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.4.

<sup>382</sup> Supervisory Report, Exhibit 1, II\_20150703\_Covered bond\_Rating methodology, p.5.

<sup>383</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, p. 30.

<sup>384</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p.6.

concerned may know without ambiguity what rights and obligations flow from it (...) <sup>385</sup>. However, the Board does not see any sign of a breach of the principle of legal certainty in the investigation by the IIO and in general in the present case regarding the interpretation of material changes to methodologies.

444. In this respect, it is relevant to consider that the principle of legal certainty is a fundamental principle of law in the EU <sup>386</sup>. The principle of legal certainty would not be breached only because of complex provisions requiring interpretation. For example, the CJEU ruled that “with regard to the alleged infringement of the principle of legal certainty, according to the case-law that principle is a fundamental principle of Community law which requires, in particular, that rules should be clear and precise, so that individuals may be able to ascertain unequivocally what their rights and obligations are and may take steps accordingly. However, where a degree of uncertainty regarding the meaning and scope of a rule of law is inherent in the rule, it is necessary to examine whether the rule of law at issue displays such ambiguity as to prevent individuals from resolving with sufficient certainty any doubts as to the scope or meaning of that rule <sup>387</sup>”.

445. The fact that the concept of “material changes” provided by Article 8(5a) and Article 14(3) of the Regulation was the subject of divergent views and was interpreted by the PSI in a way different from the interpretation explained in this Statement of Findings does not imply as such that there would be a breach of the principle of legal certainty. In addition, uncertainty is not the impression which emerges from a close examination of the content of Articles 8(5a) and 14(3) of the Regulation.

446. There is thus no breach of the principle of legal certainty in the present case.

447. Therefore, on that basis, the Board considers that the changes to the 2015 CB Methodology that were introduced through the 2016 CB Methodology must be considered as material.

448. The requirements of Articles 8(5a), 8(6) and 14(3) of the Regulation should therefore have been complied with by the PSI. However, there is clear evidence that this was not the case, as explained below:

- The PSI did not publish on its website the proposed material changes and did not invite stakeholders to submit comments for a period of one month together with a detailed explanation of the reasons for and the implications of the proposed material changes, contrary to the requirement of Article 8(5a) of the Regulation.
- The PSI was therefore unable to publish on its website the results of this consultation, contrary to the requirement of Article 8(6) of the Regulation.

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<sup>385</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 29.

<sup>386</sup> See for example CJEU, Case C-177/96, *Belgian State and Banque Indosuez and Others*, 16 October 1997, point 27.

<sup>387</sup> General Court, Case T-216/05, *Mebrom NV v Commission of the European Communities*, point 108. See also CJEU, Case C-177/96, *Belgian State and Banque Indosuez and Others*, 16 October 1997.

- The PSI did not notify ESMA of the intended material changes at the time of the consultation and did not notify ESMA of changes due to this consultation, contrary to the requirement of the third subparagraph of Article 14(3) of the Regulation.
- On 22 July 2016, the PSI notified ESMA about the update to the 2015 CB Methodology; ESMA acknowledged receipt<sup>388</sup>. This notification stated<sup>389</sup>: “We have completed the annual review of the Covered Bond rating methodology in July 2016 and concluded to make some [changes] to the methodology document although none represent modifications of the rating methodology published for the first time in July 2015. (...) The updates to the rating methodology are: i) clarifications and editorial changes to improve readability; ii) an expanded section on the quantitative analysis of the cover pool; iii) A clarification on the role of the cover pool analysis if the highest ratings are already supported by the fundamental framework analysis. (...) Existing covered bond ratings are not impacted by this update. (...) The updated rating methodology is attached to this email for your records and it will be published shortly”.

449. As part of the PSI’s semi-annual report sent on 31 January 2017 about the second half of 2016<sup>390</sup>, the PSI also referred to the updates to the 2015 CB Methodology and indicated “These clarifications are non-material changes to the rating methodology (...)”<sup>391</sup>.

450. However, none of these notifications can be considered as satisfying the requirement of the third sub-paragraph of Article 14(3) of the Regulation because they are not informing ESMA about the intended material changes at the time of the consultation and about the changes due to this consultation. They were part of the periodic information<sup>392</sup> that is transmitted to ESMA by CRAs but did not constitute a notification to ESMA for the purposes of the third subparagraph of Article 14(3) of the Regulation.

451. Therefore, regarding the changes to the 2015 CB Methodology, the PSI breached the requirements of Articles 8(5a), 8(6) and 14(3), third paragraph, of the Regulation.

452. This constitutes the infringements set out at Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation.

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<sup>388</sup> Exhibit 202, PSI’s Comments on the Supervisory Report, Document 2, RE Covered bond rating methodology annual review completed and update published.

<sup>389</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published. See also Exhibit 8, PSI’s Comments on the Supervisory Report, p. 5. The IIO notes that contrary to what the PSI initially stated, the PSI did not explicitly say in this notification that the changes were not regarded as material. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 32.

<sup>390</sup> Exhibit 46, PSI’s Comments on the Supervisory Report, Document 3, Annex 12.1 - Methodology Report. See also Exhibit 8, PSI’s Comments on the Supervisory Report, pp. 5-6.

<sup>391</sup> Exhibit 46, PSI’s Comments on the Supervisory Report, Document 3, Annex 12.1 - Methodology Report, p.3.

<sup>392</sup> See Exhibit 61, Guidelines on Periodic Reporting. See also the second subparagraph of Article 14(3) of the Regulation and Point 6 of Section II of Annex III of the Regulation.

### **Intent or negligence**

453. As a preliminary remark, the Board notes that some statements of the PSI raise doubts regarding the intent of the PSI when it assessed whether the changes to the 2015 CB Methodology were material. For example, in an email about these changes, the IRF indicated that "(...) I believe the changes that we are making to the methodology should be considered as material and probably warrants a call for comments period (...). But that should prevent us for publishing the proposed updates this week and have the final version published in August<sup>393</sup>". The fact that it was highlighted that the qualification as material changes would lead to delays in the process of adoption of the changes because of the call for comments is worrying.
454. Another worrying example is the following. When replying to the IRF who suggested to wait for the methodology review to introduce some changes regarding the cover pool analysis, an Executive Director of the PSI replied "(...) I think the following would do the trick (...). Change the title (...) to Methodology clarification (from Methodology amendment)<sup>394</sup>".
455. However, in the absence of other elements, the Board considers that overall, the factual background as set out in this Statement of Findings does not establish that there are objective factors which demonstrate that the PSI, its employees or senior managers acted deliberately to commit the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation concerning the material changes to the 2015 CB Methodology.
456. It should therefore be assessed whether there was negligence.
457. Regarding the concept of negligence for the purposes of the Regulation, the Board refers to the development already provided above (paras. 239-249).
458. Regarding the application of negligence in the present case, the Board notes the following.
459. First, regarding the relevant internal procedure in place at the time of the changes to the 2015 CB Methodology, it did not explain how the PSI would assess whether a change to a methodology is material and how the PSI would ensure compliance with its obligations under the Regulation regarding the publication, consultation of stakeholders and notification to ESMA in case of material changes.
460. For example, the Board notes that the 2014 Validation Policy did not distinguish between material and non-material changes<sup>395</sup>. It is only in the version of the 2016 Validation Policy

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<sup>393</sup> Exhibit 109, PSI's Response to the IIO's Third RFI, Document "11. 20160704 email from ANP with comments on mth update to be answered by analytics", p. 1.

<sup>394</sup> Exhibit 108, "11. 20160518 discussion between KAFU ANPO GUJO on potential ESMA reply", p. 1.

<sup>395</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p.2.



which became applicable on 7 July 2016 (i.e. this version was not applicable, according to the PSI<sup>396</sup>, to the changes to the 2015 CB Methodology) that there is a reference to “material changes”: there is one footnote which states that “Material changes to a rating methodology are changes that would impact existing ratings or substantial changes of a key rating factor<sup>397</sup>”. Furthermore, the Board notes that this definition is drafted in a narrower way than the legislative provision of Article 8(5a) of the Regulation which refers to material changes which could have an impact on a credit rating.

461. In addition, at the time of the changes to the 2015 CB Methodology, there was no internal procedure in place that would detail how the notification to ESMA of intended changes, results of the publication and final methodology had to take place regarding material changes to methodologies<sup>398</sup>. Indeed, in the 2014 Validation Policy<sup>399</sup>, there was no indication of a notification to ESMA. In the July 2016 Validation Policy<sup>400</sup>, there was a reference to the obligation to notify ESMA about the adoption of a final rating methodology but still no mention of the obligation to also notify ESMA about the intended changes and of the results of the consultation.

462. In the Board’s view, these elements denote a clear lack of care from the PSI.

463. On this point, in the PSI’s Response to the IIO’s initial Statement of Findings, the PSI indicated that “(...) the lack of a written description of the procedure for material changes cannot denote a lack of care. The 2014 Validation Policy was the very first policy of the PSI. It was not necessary to provide detailed rules for any change of methodology (...)”<sup>401</sup>. The Board agrees with the IIO in rejecting the PSI’s argumentation. In particular, according to the 2014 Validation Policy, the PSI “pursues a rigorous and systematic process for the validation and approval of new rating methodologies and the review of existing methodologies<sup>402</sup>”. This policy thus has to define the steps to be taken by the PSI regarding material changes to existing methodologies and notification to ESMA. The fact that this was the first policy of the PSI, or that PSI’s methodologies had not yet been reviewed and changed, cannot exonerate the PSI from its obligations to comply with the Regulation (which are applicable from its registration). The applicable internal procedure had to be defined so as to ensure that the PSI would comply with its obligations regarding material changes to methodologies. The PSI failed to do it, which denotes a lack of care to be taken into consideration for the assessment of negligence.

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<sup>396</sup> See Exhibit 11, PSI’s Response to the IIO’s Second RFI, Question 25. When asked by the IIO to indicate which version of the Validation Policy was followed by the PSI for the introduction of changes to the 2015 CB Methodology, the PSI indicated the following: “The methodology committee was held on July 6 2016, prior to the release of the new version of the Validation Policy of 7th July 2016. Therefore, the new version of the Validation Policy did not apply to the 2016 CB methodology update. In particular, modifications introduced to the 7th July 2016 version relating to indications on material changes do not apply to the 2016 CB methodology”.

<sup>397</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p.3.

<sup>398</sup> See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 29.

<sup>399</sup> Supervisory Report, Exhibit 7, IV\_Validation policy.

<sup>400</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p.3.

<sup>401</sup> Exhibit 216, PSI’s Response to the IIO’s initial Statement of Findings, p. 31.

<sup>402</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p.2.

464. Second, the Board considers that the evidence in the file also denotes a lack of care of the PSI when it assessed the materiality of the changes to the 2015 CB Methodology, contrary to what a professional firm in the financial services sector subject to stringent regulatory requirements would have done.
465. Indeed, the Board notes that the IIO asked the PSI to “provide supporting documents (dating from before the adoption of the 2016 CB Methodology) showing that an internal assessment was performed to determine specifically whether the changes to the 2015 CB Methodology were material<sup>403</sup>” and also to “provide supporting documents (dating from before the adoption of the 2016 CB methodology) showing the assessment conducted to conclude that “existing CB ratings [were] not impacted by this update” (the 2016 update to the CB methodology)<sup>404</sup>”.
466. In its reply, the PSI referred to the Methodology Committee Memorandum<sup>405</sup> of July 2016. According to this Methodology Committee Memorandum, “[t]his updated methodology primarily includes: i) Clarifications in wordings and clearer structuring (...)” but also “ii) an expanded section on the expected loss and rating distance dependent stresses as well as an Appendix on the technical details of the cover pool analysis. (...) iii) a clarification on the role of the cover pool analysis if the highest ratings are already supported by results of the fundamental framework analysis. Existing ratings are not impacted by this update. (...)”<sup>406</sup>. In addition, in the section related to “Recommendation”, the Methodology Committee Memorandum indicates “Approve publication of annual update. (...) No ratings are impacted as the update primarily adds clarifications, expands on the modelling approach and gives an indication for the cover pool analysis for covered bond ratings primarily based on the fundamental benefits<sup>407</sup>”.
467. This Methodology Committee Memorandum thus contains the conclusion of the PSI regarding the fact that no rating was impacted by the changes to the 2015 CB Methodology. However, there is no detail in this memorandum on how this assessment was performed. In particular, the fact that the PSI did not provide any document that would comprise this assessment contradicts the 2014 Validation Policy, which stated that: “For a change in methodology, Scope Ratings’ analytical team conducts a preliminary impact study on existing ratings in order to assess and test the impact of the proposal<sup>408</sup>”, thus pointing to the existence of an impact study that should have been conducted by the analytical team in order to assess the impact of changes on existing ratings. The Board notes that the IIO requested the PSI to “(...) provide a copy of the preliminary impact study conducted in 2016 to assess and test the impact of the proposed changes to the 2015 CB methodology<sup>409</sup>”.

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<sup>403</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 24.

<sup>404</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 25.

<sup>405</sup> Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 25.

<sup>406</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.3.

<sup>407</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.3.

<sup>408</sup> Supervisory Report, Exhibit 7, IV\_Validation policy, p.2, step (vi).

<sup>409</sup> Exhibit 14, PSI’s Response to the IIO’s Second RFI, Question 24.

The PSI did not provide this document and argued that “an impact study according to the internal policies was not needed<sup>410</sup>”. The Board agrees with the IIO and rejects the PSI’s argument<sup>411</sup> since the above-mentioned quote from the Validation Policy clearly provides for a preliminary impact study for a change in methodology.

468. In addition, in the above-mentioned Methodology Committee Memorandum, there is no thorough assessment (or evidence of such assessment) of whether the fact that no rating was impacted by the changes to the 2015 CB Methodology would be sufficient to consider that the changes to the 2015 CB Methodology are not material for the purposes of the Regulation. As shown<sup>412</sup> by the above-mentioned Methodology Committee Memorandum<sup>413</sup>, the PSI has indeed focused on whether changes to the 2015 CB Methodology had an actual impact on existing ratings.

469. In this respect, the Board notes that the IIO expressly requested the PSI to “provide all relevant documentation dating from before the adoption of the 2016 CB Methodology that would show an assessment by the PSI of the notion of “material change” for the purposes of the CRA Regulation” and in particular “all documentation on the basis of which the PSI would have drawn the conclusion that the only criterion to be taken into account when assessing whether a change to a methodology is material is its actual impact on existing ratings<sup>414</sup>”. The PSI did not provide any specific documentation in its response that would have shown an assessment of the concept of “material changes” in general. No specific documentation was found in the file, which would show a detailed assessment at that time of the concept of “material changes” and that would justify (for example, on the basis of a detailed legal assessment) the PSI’s assumption that “material changes” should be interpreted in a narrow way and, for example, should be always dependant on the existence of an actual impact on existing ratings. The PSI only referred to the internal meetings that were held to discuss the changes in the 2015 CB Methodology and indicated that “At no point it was identified that the clarifications introduce material changes to the

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<sup>410</sup> Exhibit 14, PSI’s Response to the IIO’s Second RFI, Question 24.

<sup>411</sup> In its response to Question 24 of the IIO’s Second RFI, the PSI refers to a document named “Q24.121\_20140704 Validation Process.pdf”. This document was not provided with the PSI’s Response to the IIO’s Second RFI. However, it was provided by the PSI with its response to the IIO’s First RFI under a different name (“Appendix1-Validation Policy”) as Document 13 and corresponds to Supervisory Report, Exhibit 7, IV\_Validation policy. Under Section 121/02 (on the general validation process for methodology developments) of that document, the different steps in the validation process of new methodologies and the review process of existing methodologies are explained. With regards to existing methodologies, step (vi) provides that “for a change in methodology, Scope Ratings’ analytical team conducts a preliminary impact study on existing ratings in order to assess and test the impact of the proposal”.

In its response to Question 24 of the IIO’s Second RFI, the PSI refers to Section 121/03 of the document (on the analytical elements considered for methodology developments) to substantiate its argument that no preliminary impact study was needed. However, this section refers exclusively to the analytical elements of methodology proposals (“methodology proposals used by the analytical team include fundamental research and / or statistical quantitative analysis based on publicly available information, academic research, data acquired by Scope Ratings from reliable providers or proprietary data. The development work performed by the analytical team includes back-testing validation, which may take different forms, such as quantitative back-testing (see example appendix 1, SME Scoring), fundamental peer group analysis or case study or an assessment of the past performance of market standard modelling processes, including academic research”) and, therefore, does not exclude the conduct of a preliminary impact study on existing ratings in accordance with Section 121/02, step (vi), of the 2014 Validation Policy.

<sup>412</sup> See also the arguments raised by the PSI in this case regarding the interpretation of “material changes”.

<sup>413</sup> Exhibit 45, PSI’s Response to the IIO’s First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final.

<sup>414</sup> Exhibit 14, PSI’s Response to the IIO’s Second RFI, Question 23.

methodology but rather provide for further clarity on existing points<sup>415</sup>". Minutes of these internal meetings do not exist, but the PSI provided chains of emails about these meetings<sup>416</sup>. In these documents, there is no assessment in general of the concept of "material changes".

470. On the basis of the exchange of emails, there is evidence in the file of conflicting views within the PSI on whether the changes to the 2015 CB Methodology should be considered as material.

471. In an email from the IRF regarding the update of the 2015 CB methodology, the IRF indicated that "Although there is no additional or removal of rating factors, I believe the changes that we are making to the methodology should be considered as material and probably warrants a call for comments period – I will send you separately the guidance published by ESMA on the topic. But that should prevent us from publishing the proposed updates this week and have the final version published in August<sup>417</sup>".

472. The Reply received by the IRF from the PSI's Executive Director was the following<sup>418</sup>: "Would disagree – in my view this is not a material change – Apart from the CP analysis for fundamental based ratings these are only clarifications – let's discuss though. My current view based on the Q&A: Material changes to methodologies, models, or key rating assumptions might include among others:

i) a change in the key criteria used; KF – there is no change

ii) a change in the key rating assumptions and key variables used in the rating methodology; - we already provided the concepts and this simply explains them further

iii) a change in the respective weight of the qualitative and quantitative factors; - no change here (would only if we change the fundamental uplift)

iv) a change in the way driving factors are assessed; or KF: no change either

v) a change that has a direct or indirect impact on a significant number of credit ratings. KF There is no rating impact as we took from existing ratings the expansion [sic]".

473. There is thus clear evidence in the file that the IRF was initially of the view that the changes might be material. Despite this statement from the IRF, the material nature of the changes seems to have been excluded based on a limited and careless analysis of the criteria of Answer 7 of the Q&A, which are clearly non-exhaustive (as shown by the use of "among others").

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<sup>415</sup> Exhibit 14, PSI's Response to the IIO's Second RFI, Question 23.

<sup>416</sup> Exhibit 19, PSI's Response to the IIO's Third RFI, Question 11.

<sup>417</sup> Exhibit 109, PSI's Response to the IIO's Third RFI, Document "11. 20160704 email from ANP with comments on mth update to be answered by analytics", p. 1.

<sup>418</sup> Exhibit 204, PSI's Response to the IIO's Third RFI, Document "11. 20160704 email to ANPO STBU GUJO answering questions of ANPO on the update and ration".

474. Therefore, the Board finds, on the basis of the evidence in the file, a lack of care of the PSI when it analysed whether the changes to the 2015 CB Methodology were material.
475. On this point, the Board notes that in the PSI's Response to the IIO's initial Statement of Findings, the PSI indicated that "(...) the PSI saw the difference between the 2015 CB Methodology and the 2016 CB Methodology only as clarifications. Any in-depth assessment of the materiality would not have been in line with assessment (...). Additionally, the cited e-mail, which seems to show conflicting views regarding the materiality of the changes, is taken out of context. This was a difficult situation for the PSI, since the Regulation does not clearly define the notion of "materiality". Therefore, our client was as diligent as possible by making use of the guidance issued by ESMA in the form of Q&A. Still on the basis of these Q&A, there were diverging views internally between CB team and IRF on the interpretation. A final position was reached during a call on 6 July 2019 [sic: 2016] that the changes were not material<sup>419</sup>".
476. The Board agrees with the IIO and rejects the PSI's argumentation. The point raised by the PSI that an in-depth assessment of the materiality of the changes by the PSI would not have been consistent with its views that the changes were only clarifications is also not acceptable, because this is precisely after a diligent and in-depth assessment (that it did not perform in the case at hand) that the PSI could have been in a position to conclude about the materiality / clarifying nature of the changes. Furthermore, the IRF's initial view that the changes were material should have in fact led to extra care from the PSI who was already subject to a high standard of care. Indeed, the IRF's initial view would have even more justified a detailed assessment of the changes. As already mentioned above, some internal exchanges of mails could even point to an infringement committed intentionally.
477. Finally, the Board notes that although there were some conflicting views within the PSI on the materiality of the changes, the PSI did not contact ESMA in advance to check whether these changes should be considered as material. There were some discussions between the PSI and ESMA's Supervision Department in 2015<sup>420</sup> and early 2016<sup>421</sup> to discuss (among others) the analysis conducted by the PSI under the 2015 CB Methodology<sup>422</sup>. The PSI even argued that the changes introduced in the 2015 CB Methodology "(...) were primarily introduced in order to address comments by ESMA at a call in May 2016 that highlighted some perceived ambiguities in the methodology<sup>423</sup>". The PSI also affirmed that "we provided clear notifications to ESMA's supervision department at the time on our understanding of the non-materiality of the changes to the CB methodology. Scope was therefore fully transparent to ESMA at the time of its understanding of ESMA's criteria on the materiality of a methodology change<sup>424</sup>".

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<sup>419</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, p. 32.

<sup>420</sup> Supervisory Report, Exhibit 88, XXX\_1144\_20150310\_Memo conf call ESMA scope validation covered bond methodology.

<sup>421</sup> Exhibit 68, PSI's Response to the IIO's Third RFI, Document "20160504 Memo call ESMA Scope Covered bond Rating action Sept 2015" (attachment to Exhibit 33).

<sup>422</sup> See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 4.

<sup>423</sup> Exhibit 14, PSI's Response to the IIO's Second RFI, Question 23.

<sup>424</sup> Exhibit 14, PSI's Response to the IIO's Second RFI, Question 24.



478. However, the Board finds, on the basis of the evidence, that, during and despite these contacts, the PSI did not raise any questions to ESMA regarding whether the changes to the 2015 CB Methodology should be considered as material ones. On the contrary, the PSI only notified ESMA *ex post* on 22 July 2016<sup>425</sup> about the update to the 2015 CB Methodology. The Board notes that contrary to the PSI's initial statements<sup>426</sup>, the PSI did not explicitly inform ESMA in this notification that the changes were not regarded as material. The PSI only indicated that "We have completed the annual review of the Covered Bond rating methodology in July 2016 and concluded to make some [sic] to the methodology document although none represent modifications of the rating methodology published for the first time in July 2015" and that "Existing covered bond ratings are not impacted by this update<sup>427</sup>". It is only a few months later that, as part of the PSI's semi-annual report sent on 31 January 2017 about the second half of 2016<sup>428</sup>, the PSI indicated to ESMA that "These clarifications are non-material changes to the rating methodology (...) <sup>429</sup>". On this basis, the Board also rejects the argument, reiterated in the written submissions<sup>430</sup>, that "considering that the Regulation does not clearly define the notion of "materiality" the PSI was as diligent as possible".
479. Overall, the above elements denote a lack of care by the PSI to analyse whether the changes to the 2015 CB Methodology were material and to ensure that the relevant provisions of the Regulation are complied with.
480. As a professional firm in the financial services sector subject to stringent regulatory requirements, the PSI is required to take special care in assessing the risks that its acts or omissions entail, and has failed to take that care; and as result of that failure, it has not foreseen the consequences of its acts or omissions, including particularly its infringement of the Regulation, in circumstances when a person in such a position who is normally informed and sufficiently attentive could not have failed to foresee those consequences.
481. Therefore, it is considered that the PSI has been negligent when committing the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation concerning the material changes to the 2015 CB Methodology.

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<sup>425</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published. See also Exhibit 8, PSI's Comments on the Supervisory Report, p. 5.

<sup>426</sup> See Exhibit 8, PSI's Comments on the Supervisory Report, p. 5. See also Exhibit 11, PSI's Response to the IIO's First RFI, Question 32.

<sup>427</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published.

<sup>428</sup> Exhibit 46, PSI's Comments on the Supervisory Report, Document 3, vAnnex12.1 - Methodology Report. See also Exhibit 8, PSI's Comments on the Supervisory Report, pp. 5 and 6.

<sup>429</sup> Exhibit 46, PSI's Comments on the Supervisory Report, Document 3, Annex12.1 - Methodology Report, p.3.

<sup>430</sup> See written submissions to the Board, p. 29.



## **Fines**

### **Determination of the basic amounts**

#### **Infringement set out at Point 3a of Section II of Annex III**

482. Article 36a of the Regulation provides in paragraph 2 as follows:

“2. The basic amount of the fines referred to in paragraph 1 shall be included within the following limits:

(e) for the infringements referred to in points 2, 3a to 5 of Section II of Annex III, the fines shall amount to at least EUR 25 000 and shall not exceed EUR 75 000; [...]

In order to decide whether the basic amount of the fines should be set at the lower, the middle or the higher end of the limits set out in the first subparagraph, ESMA shall have regard to the annual turnover in the preceding business year of the credit rating agency concerned. The basic amount shall be at the lower end of the limit for credit rating agencies whose annual turnover is below EUR 10 million, the middle of the limit for the credit rating agencies whose annual turnover is between EUR 10 and 50 million and the higher end of the limit for the credit rating agencies whose annual turnover is higher than EUR 50 million”.

483. It has been established that the PSI committed the infringement set out at Point 3a of Section II of Annex III of the Regulation, by not notifying ESMA of the intended material changes to the 2015 CB Methodology.

484. To determine the basic amount of the fine, the Board has regard to the PSI’s annual turnover in the preceding business year.

485. In 2015, the PSI’s total turnover was EUR 4 351 165 and its turnover for credit rating services amounted to EUR 2 259 299<sup>431</sup>.

486. Thus, the basic amount of the fine for the infringement listed in Point 3a of Section II of Annex III of the Regulation is set at the lower end of the limit of the fine set out in Article 36a(2)(e) of the Regulation and shall amount to at least EUR 25 000.

#### **Infringement set out at Point 3b of Section II of Annex III**

487. Article 36a of the Regulation provides in paragraph 2 as follows:

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<sup>431</sup> Exhibit 76, Transparency\_Report\_2015, p.11. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 1.

“2. The basic amount of the fines referred to in paragraph 1 shall be included within the following limits:

(e) for the infringements referred to in points 2, 3a to 5 of Section II of Annex III, the fines shall amount to at least EUR 25 000 and shall not exceed EUR 75 000; [...]

In order to decide whether the basic amount of the fines should be set at the lower, the middle or the higher end of the limits set out in the first subparagraph, ESMA shall have regard to the annual turnover in the preceding business year of the credit rating agency concerned. The basic amount shall be at the lower end of the limit for credit rating agencies whose annual turnover is below EUR 10 million, the middle of the limit for the credit rating agencies whose annual turnover is between EUR 10 and 50 million and the higher end of the limit for the credit rating agencies whose annual turnover is higher than EUR 50 million”.

488. It has been established that the PSI committed the infringement set out at Point 3b of Section II of Annex III of the Regulation, by not publishing on its website the proposed material changes to the 2015 CB Methodology that could have an impact on the credit ratings together with an explanation of the reasons for and the implications of those changes.

489. To determine the basic amount of the fine, the Board has regard to the PSI’s annual turnover in the preceding business year.

490. In 2015, the PSI’s total turnover was EUR 4 351 165 and its turnover for credit rating services amounted to EUR 2 259 299<sup>432</sup>.

491. Thus, the basic amount of the fine for the infringement listed in Point 3b of Section II of Annex III of the Regulation is set at the lower end of the limit of the fine set out in Article 36a(2)(e) of the Regulation and shall amount to at least EUR 25 000.

#### Infringement set out at Point 4a of Section III of Annex III

492. Article 36a of the Regulation provides in paragraph 2 as follows:

“2. The basic amount of the fines referred to in paragraph 1 shall be included within the following limits:

(h) for the infringements referred to in point 20a of Section I of Annex III, points 4 to 4c, 6, 8 and 10 of Section III of Annex III, the fines shall amount to at least EUR 90 000 and shall not exceed EUR 200 000; [...]

In order to decide whether the basic amount of the fines should be set at the lower, the middle or the higher end of the limits set out in the first subparagraph, ESMA shall have regard to the annual turnover in the preceding business year of the credit rating agency

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<sup>432</sup> Exhibit 76, Transparency\_Report\_2015, p. 11. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 1.

concerned. The basic amount shall be at the lower end of the limit for credit rating agencies whose annual turnover is below EUR 10 million, the middle of the limit for the credit rating agencies whose annual turnover is between EUR 10 and 50 million and the higher end of the limit for the credit rating agencies whose annual turnover is higher than EUR 50 million”.

493. It has been established that the PSI committed the infringement set out at Point 4a of Section III of Annex III of the Regulation, by not having informed ESMA and by not having published immediately on its website the results of the consultation on the proposed material changes to the 2015 CB Methodology together with a detailed explanation thereof.

494. To determine the basic amount of the fine, the Board has regard to the PSI’s annual turnover in the preceding business year.

495. In 2015, the PSI’s total turnover was EUR 4 351 165 and its turnover for credit rating services amounted to EUR 2 259 299<sup>433</sup>.

496. Thus, the basic amount of the fine for the infringement listed in Point 4a of Section III of Annex III of the Regulation is set at the lower end of the limit of the fine set out in Article 36a(2)(h) of the Regulation and shall amount to at least EUR 90 000.

### **Aggravating factors**

497. Annex IV of the Regulation lists the aggravating factors to be taken into consideration for the adjustment of the fine. Their application to the present case is assessed below.

Annex IV, Point I. 1. If the infringement has been committed repeatedly, for every time it has been repeated, an additional coefficient of 1,1 shall apply.

498. Each of the infringements at points 3a and 3b of Section II of Annex III and point 4a of Section III of Annex III has only been committed once in relation to the changes to the 2015 CB Methodology through the adoption of the 2016 CB Methodology.

499. Therefore, this aggravating factor is not applicable.

Annex IV, Point I. 2. If the infringement has been committed for more than six months, a coefficient of 1,5 shall apply.

500. Given their nature, the infringements set out in Points 3a and 3b of Section II of the Regulation can only be committed until a new rating methodology or the proposed material changes to a methodology are adopted. Taking into account that the process for the development and approval of the 2016 CB Methodology started on 24 May 2016<sup>434</sup> and that

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<sup>433</sup> Exhibit 76, Transparency\_Report\_2015, p.11. See also Exhibit 11, PSI’s Response to the IIO’s First RFI, Question 1.

<sup>434</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p. 1; Supervisory Report, Exhibit 47, IRF Comments and areas for improvements on Covered Bond Rating Methodology 2016.

the 2016 CB Methodology was finally adopted<sup>435</sup> and published<sup>436</sup> on 22 July 2016, the infringements could not have been committed for more than six months.

501. With regard to the infringement set out in Point 4a of Section III, it could be argued that the same reasoning should apply, meaning that the infringement lasted only until the adoption<sup>437</sup> and publication<sup>438</sup> of the 2016 CB Methodology and the corresponding notification to ESMA<sup>439</sup> (i.e. less than six months). Another possibility would be to consider that the infringement lasted for as long as the results of the consultation were not published on the PSI's website. Since, in this case, the results of the consultation were never published because there was no consultation, there are some uncertainties about the exact duration of the infringement. In any event, the Board considers that because of this uncertainty, in the present circumstances, the PSI should be given the benefit of the doubt and, therefore, the present aggravating factor should not apply.

502. For the above reasons, the present aggravating factor is not applicable.

Annex IV, Point I. 3. If the infringement has revealed systemic weaknesses in the organisation of the credit rating agency, in particular in its procedures, management systems or internal controls, a coefficient of 2,2 shall apply.

503. The Board notes that the Regulation does not provide guidance on what constitutes “systemic weaknesses in the organisation of the credit rating agency”. However, based on the wording of the terms used, not all weaknesses in the procedures, management systems or the internal controls will necessarily constitute “systemic weaknesses in the organisation of a CRA”.

504. There is insufficient indication in the file that would point to systemic weaknesses in the organisation of the PSI, in particular in its procedures, management systems or internal controls.

505. This aggravating factor is thus not applicable.

Annex IV, Point I. 4. If the infringement has had a negative impact on the quality of the ratings rated by the credit rating agency concerned, a coefficient of 1,5 shall apply.

506. Evidence of a negative impact on the ratings could for example be inferred from evidence of deviations of ratings between the ratings that were issued by the PSI and the ratings that would have been issued if there would have been no infringement of Points 3a and 3b of Section II and Point 4a of Section III of Annex III of the Regulation by the PSI concerning the issuance of CB ratings following the material changes to the 2015 CB Methodology, if these deviations could not be explained by other reasons. In particular,

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<sup>435</sup> Supervisory Report, Exhibit 49, I\_2016 cb methodology update - Approval by Annick (Review function).

<sup>436</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final, p.1.

<sup>437</sup> Supervisory Report, Exhibit 49, I\_2016 cb methodology update - Approval by Annick (Review function).

<sup>438</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final.

<sup>439</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published.

regarding the infringement related to the lack of public consultation about the intended material changes to the 2015 CB Methodology, one could consider that if this consultation would have taken place, it might have brought amendments to the CB Methodology that would have improved the quality of the CB ratings issued by the PSI. The impact on the quality of the ratings would be more difficult to consider regarding the infringement related to the lack of notification to ESMA about the material changes. In any event, in the present case, there is no evidence in the file that would support a demonstration of a negative impact on the quality of the CB ratings issued by the PSI.

507. It should also be noted that the PSI indicated the following: “Scope considers regarding the quality of the ratings issued by Scope that, again, since the adjustments were made in respect of components of the 2015 CB methodology which were not a driver for the ratings that were issued under the 2015 CB methodology, this would not have had any impact on the quality in terms of the level of the assigned ratings if Scope would have carried out a public consultation and would have notified ESMA of the intended changes<sup>440</sup>”.

508. On that basis, it is not established in the present case that the infringements of Points 3a and 3b of Section II and Point 4a of Section III of Annex III of the Regulation committed by the PSI concerning the material changes to the 2015 CB Methodology had a negative impact on the quality of the ratings.

509. The aggravating factor is, therefore, not applicable.

Annex IV, Point I. 5. If the infringement has been committed intentionally, a coefficient of 2 shall apply.

510. This aggravating factor is not applicable because there is no sufficient evidence that the infringements by the PSI of Points 3a and 3b of Section II of Annex III and 4a of Section III of Annex III of the Regulation have been committed intentionally.

Annex IV, Point I. 6. If no remedial action has been taken since the breach has been identified, a coefficient of 1,7 shall apply.

511. The Board notes that due to the nature of the infringements, remedial actions are to some extent limited regarding for example the call for comments of the public on the intended material changes or the notification to ESMA of the intended material changes. Since the material changes to the 2015 CB Methodology were adopted without any consultation of the public, it is no longer possible to organise a call for comments or to notify ESMA about the intended changes.

512. Nevertheless, the Board notes that a number of measures relevant for the purposes of this aggravating factor were taken. This includes the fact that ESMA was notified by the

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<sup>440</sup> Exhibit 11, PSI's Response to the IO's First RFI, Question 34.

PSI about the update to the 2015 CB Methodology<sup>441</sup>. This also covers the changes to the Validation Policy which have taken place since 2016 and which aimed at providing a more detailed procedure regarding material changes to methodologies<sup>442</sup>.

513. As explained below in relation to the mitigating factor of Point II. 4 of Annex IV of the Regulation, the Board does not consider that these measures are sufficient to ensure that no similar infringement will be committed in the future. Nevertheless, for the purposes of the aggravating factor of Point I.6 of Annex IV of the Regulation, the Board considers that overall, a number of remedial actions have been taken.

514. The aggravating factor is thus not applicable.

Annex IV, Point I. 7. If the credit rating agency's senior management has not cooperated with ESMA in carrying out its investigations, a coefficient of 1,5 shall apply.

515. The Board considers that there is no evidence that the PSI (including their senior management<sup>443</sup>) has not cooperated with her during her investigation. Similarly, there is no sign in the file of a lack of cooperation of the PSI at the stage of the investigation by ESMA's Supervision Department.

516. Therefore, it is considered that the aggravating factor relating to a lack of cooperation is not applicable.

### **Mitigating factors**

517. Annex IV of the Regulation lists the mitigating factors to be taken into consideration for the adjustment of the fine. Their application to the present case is assessed below.

Annex IV, Point II. 1. If the infringement relates to a breach listed in Section II or III of Annex III and has been committed for fewer than 10 working days, a coefficient of 0,9 shall apply.

518. The infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation relate to breaches listed in Section II or III.

519. As explained above, the Board considered that it is not established that the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation have been committed for more than 6 months.

520. For the present mitigating factor, the Board must determine whether they have been committed for fewer than 10 working days. The Board notes in this respect that (i) the consultation period on proposed material changes to a methodology should be for a period

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<sup>441</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published.

<sup>442</sup> See Exhibit 11, PSI's Response to the IIO's First RFI, Question 29.

<sup>443</sup> The IIO's RFIs were sent to and the responses were received from the PSI's contact person as designated by the PSI's legal representative.



of 1 month according to Article 8(5a) of the Regulation, (ii) the process for the development and approval of the 2016 CB Methodology started on 24 May 2016<sup>444</sup>, (iii) all proposed material changes were agreed internally on 6 July 2016<sup>445</sup> (when the questions from the IRF were removed from the draft and the next planned actions were to update the memo sheet and to gain approval from the committee chair and the IRF for publication), and (iv) the 2016 CB Methodology was finally adopted<sup>446</sup>, published<sup>447</sup> and notified<sup>448</sup> to ESMA on 22 July 2016.

521. In these specific circumstances, the Board considers that, even though there are some uncertainties about the precise duration, the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III of the Regulation cannot be considered as having been committed for fewer than 10 working days.

522. This mitigating factor is thus not applicable.

Annex IV, Point II. 2. If the credit rating agency's senior management can demonstrate that they have taken all the necessary measures to prevent the infringement, a coefficient of 0.7 shall apply.

523. The Board notes that in her RFI, the IIO requested the PSI to provide any documentation showing specifically the measures taken by the PSI's senior management to prevent the infringements<sup>449</sup>. The PSI provided numerous documents<sup>450</sup>, including different versions of the Validation Policy<sup>451</sup>. In particular, the PSI indicated that it is "(...) of the view that adequate provisions are contained in (...) policies and procedures to reflect

<sup>444</sup> Supervisory Report, Exhibit 51, VI\_IRF assessment CB methodology\_2016, p.1; Supervisory Report, Exhibit 47, IRF Comments and areas for improvements on Covered Bond Rating Methodology 2016.

<sup>445</sup> Exhibit 45, PSI's Response to the IIO's First RFI, Document 53 CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval – Final, p.2.

<sup>446</sup> Supervisory Report, Exhibit 49, I\_2016 cb methodology update - Approval by Annick (Review function).

<sup>447</sup> Supervisory Report, Exhibit 2, VI\_20160722\_Covered bond rating methodology\_Annual update\_Final.

<sup>448</sup> Supervisory Report, Exhibit 87, Covered bond rating methodology annual review completed and update published.

<sup>449</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 33.

<sup>450</sup> See Exhibit 11, PSI's Response to the IIO's First RFI, Question 33. See also Exhibit 11, PSI's Response to the IIO's First RFI, Questions 22 to 29, and in particular, Exhibit 205, PSI's Response to the IIO's First RFI, Document 12, Covered Bond Methodology 2017; Exhibit 56, PSI's Response to the IIO's First RFI, Document 50, IRF Assessment – Covered Bond Rating Methodology\_2017; Exhibit 57, PSI's Response to the IIO's First RFI, Document 51, IRF approval; Exhibit 206, PSI's Response to the IIO's First RFI, Document 52, IRF - CB Rating Methodology 2016 Review May 2016; Exhibit 45, PSI's Response to the IIO's First RFI, Document 53, CB Methodology Committee Memo 20160706 - Post cmt Rating sheet for approval - Final; Exhibit 42, PSI's Response to the IIO's First RFI, Document 54, 20160504\_Dexia Kommunalbank\_Rating Report\_Initial rating; Exhibit 207, PSI's Response to the IIO's First RFI, Document 55, 20160708\_Bankia\_Rating Report\_Initial rating; Exhibit 208, PSI's Response to the IIO's First RFI, Document 56, Compagnie de Financement Foncier Rating Report 2017; Exhibit 209, PSI's Response to the IIO's First RFI, Document 57, Bausparkasse Wüstenrot AG Rating Report 2017.

<sup>451</sup> Exhibit 210, PSI's Response to the IIO's First RFI, Document 14, Policy for Approval Review Validation July 2016; Exhibit 211, PSI's Response to the IIO's First RFI, Document 15, Policy for Approval Review Validation October 2016; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual. See also Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings Rating Methodologies Process Manual April 2019".

the requirements to surrounding new rating methodologies or the proposed material changes to rating methodologies<sup>452</sup>”.

524. However, the Board considers that the applicable Validation Policy at the time of the infringements was not adequate regarding the material changes to methodologies. More generally, there is no evidence in the file that would demonstrate that the PSI's senior management has taken all the necessary measures to prevent the infringement.

525. This mitigating factor is thus not applicable.

526. The comments from the PSI in its Response to the IIO's initial Statement of Findings do not change this conclusion. The PSI indicated that “(...) the direct involvement of senior management in the actual decision process is the strongest form of prevention. This was the case for the adaption of the 2016 CB Methodology (...)”<sup>453</sup>. However, the fact that senior management participated to the discussions that led to the update of the 2015 CB Methodology cannot be seen as the senior management having taken “all the necessary measures to prevent the infringement”. On the contrary, the Board notes that this is precisely because of discussions with the senior management<sup>454</sup> that the initial view of the IRF about the materiality of the changes was not followed.

Annex IV, Point II. 3. If the credit rating agency has brought quickly, effectively and completely the infringement to ESMA's attention, a coefficient of 0,4 shall apply.

527. The Board finds that this mitigation factor is not applicable because the PSI has not brought “quickly, effectively and completely the infringement to ESMA's attention”.

528. On the contrary, the infringements came to ESMA's attention through the investigation conducted by ESMA's Supervision Department and the subsequent IIO's investigation and were not revealed by the PSI.

529. In its Response to the IIO's initial Statement of Findings, the PSI held that “(...) it is sufficient for this mitigating factor if a CRA brings all relevant facts to ESMA's attention (...)” and stated that “(...) the PSI notified the clarification of its Methodology. ESMA confirmed the receipt of this notification. (...) and the notification showed that ESMA did not need more information<sup>455</sup>”. The PSI reiterated the argument in the written submissions to the Board<sup>456</sup>.

530. The Board rejects the argument of PSI. To benefit from a mitigating factor, a CRA has to go beyond its legal obligations under the Regulation (including the ones regarding the notification of new methodologies and the submission of periodic information to ESMA). Moreover, the notification to ESMA about the changes to the 2015 CB Methodology did

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<sup>452</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 33.

<sup>453</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, paras 91 and 92.

<sup>454</sup> Exhibit 204, PSI's Response to the IIO's Third RFI, Document “11. 20160704 email to ANPO STBU GUJO answering questions of ANPO on the update and ration”.

<sup>455</sup> Exhibit 216, PSI's Response to the IIO's initial Statement of Findings, paras. 95-96.

<sup>456</sup> See written submissions to the Board, p. 30.

not at all point to an infringement (or at least an incident / concern) and cannot be considered as a notification to ESMA in an effective and complete manner for the purposes of Annex IV, Section II, Point 3 of the Regulation.

Annex IV, Point II. 4. If the credit rating agency has voluntarily taken measures to ensure that similar infringement cannot be committed in the future, a coefficient of 0,6 shall apply.

531. Regarding this mitigating factor, the Board notes that since July 2016, the Validation Policy distinguishes between material and non-material changes to methodologies<sup>457</sup>. In this respect, the 2017, 2018 and 2019 Rating Methodologies Process Manuals<sup>458</sup> provide detailed explanations of the steps to be followed regarding material changes to methodologies, including:

- Once proposed material changes are approved, they are published as a call for comments on the PSI's website for a period of, at least, one month. The publication of the proposed changes is accompanied by a detailed explanation of the reasons for and implication of those changes<sup>459</sup>;
- The final methodology, together with a press release explaining in a comprehensive manner the nature and rationale of the changes, is published on the PSI's website. The responses received during the consultation and the results of it are also published on the PSI's website<sup>460</sup>;

<sup>457</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p.3; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p.3; Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p.3; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p.4; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p.4; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p.5; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58, Scope Ratings\_Rating Methodologies Process Manual, p.5; and Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings\_Rating Methodologies Process Manual April 2019", p.5.

<sup>458</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58 Scope Ratings\_Rating Methodologies Process Manual; Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings\_Rating Methodologies Process Manual April 2019".

<sup>459</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p.5; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p.6; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p.6; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p.7; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58 Scope Ratings\_Rating Methodologies Process Manual, p.7; Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings\_Rating Methodologies Process Manual April 2019", p.7.

<sup>460</sup> Exhibit 34, PSI's Response to the IIO's First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p.5; Exhibit 35, PSI's Response to the IIO's First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p.6; Exhibit 36, PSI's Response to the IIO's First RFI, Document 45 Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p.6; Exhibit 37, PSI's Response to the IIO's First RFI, Document 44 Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p.7; Exhibit 38, PSI's Response to the IIO's First RFI, Document 58 Scope Ratings\_Rating Methodologies Process Manual, p. 7; Exhibit 39, PSI's Response to the IIO's Third RFI, Document "3. Scope Ratings\_Rating Methodologies Process Manual April 2019", p.7.

- The IRF informs the Independent Directors as well as ESMA about the material changes introduced to the methodologies, as well as of the results of the consultation<sup>461</sup>.

532. It should also be noted that while in the 2016 Validation Policies, “material changes” were defined by the PSI as “changes that would impact existing ratings or substantial changes of a key rating factor”<sup>462</sup>, “material changes” are defined in the 2017, 2018 and 2019 Rating Methodologies Process Manuals as “substantial changes to one or more key rating factor(s) or their weight (...) or changes that impact already assigned ratings”<sup>463</sup>. These elements were indeed taken into consideration by the PSI in the analysis that it performed regarding the materiality of changes in the update to the CB Methodology dated 31 July 2018<sup>464</sup>.

533. Therefore, under the current applicable internal procedure, it is clear that proposed material changes have to be published with a call for comments, the results of this consultation also have to be published and ESMA is to be notified about the publication of material changes to rating methodologies and the results of the consultation if applicable.

534. However, rejecting the PSI’s argument, also reiterated in the context of the written submissions to the Board<sup>465</sup>, the Board agrees with the IIO and notes that the definition of “material changes” is still very limitative (contrary for example to Answer 7 of the Q&A which provides a non-exhaustive list) and does not cover all cases of material changes for the purposes of the Regulation. In the definition given by the PSI to “material changes”, the characterisation of a change as “material” is, and has always been, dependent on whether it actually impacts existing / already assigned ratings. However, as already noted, one of the factors to be taken into consideration is whether, due to the intended changes to the methodology, there could be a potential impact on ratings under this methodology and not whether this impact would actually materialise.

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<sup>461</sup> Exhibit 34, PSI’s Response to the IIO’s First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p.5; Exhibit 35, PSI’s Response to the IIO’s First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p.6; Exhibit 36, PSI’s Response to the IIO’s First RFI, Document 45, Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p.6; Exhibit 37, PSI’s Response to the IIO’s First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p.7; Exhibit 38, PSI’s Response to the IIO’s First RFI, Document 58 Scope Ratings\_Rating Methodologies Process Manual, p.7; Exhibit 39, PSI’s Response to the IIO’s Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p.8.

<sup>462</sup> Supervisory Report, Exhibit 71, II\_Policy for approval review validation\_July 2016, p.3; Supervisory Report, Exhibit 72, III\_Policy for approval review validation\_October 2016, p.3

<sup>463</sup> Exhibit 34, PSI’s Response to the IIO’s First RFI, Document 43, Scope Ratings\_Rating Methodologies Process Manual posted in Scope 6 December 2016, p.3; Exhibit 35, PSI’s Response to the IIO’s First RFI, Document 46, Scope Ratings\_Revised Rating Methodologies Process Manual yellow, p. 4; Exhibit 36, PSI’s Response to the IIO’s First RFI, Document 45 Scope Ratings\_Rating Methodologies Process Manual\_Aug17, p.4; Exhibit 37, PSI’s Response to the IIO’s First RFI, Document 44, Scope Ratings\_Rating Methodologies Process Manual\_1 Feb 2018, p.5; Exhibit 38, PSI’s Response to the IIO’s First RFI, Document 58 Scope Ratings\_Rating Methodologies Process Manual, p.5; Exhibit 39, PSI’s Response to the IIO’s Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p.5.

<sup>464</sup> Exhibit 69, PSI’s Response to the IIO’s Second RFI, Document “5.Q10.20180731 CB Methodology Final Publication Committee”, p.2.

<sup>465</sup> See written submissions to the Board, p. 30.

535. In addition, there is no indication in the 2019 Rating Methodologies Process Manual<sup>466</sup> of a notification to ESMA of “intended” material changes to methodologies, when a call for comments is published<sup>467</sup>.

536. Therefore, the Board considers that despite the above-mentioned measures regarding material changes to methodologies (which were taken voluntarily by the PSI), it is not established that these measures would prevent a similar infringement to be committed in the future.

537. The mitigating factor is therefore not applicable.

### **Determination of the adjusted fines**

#### Infringement set out at Point 3a of Section II of Annex III

538. In accordance with Article 36a(3) of the Regulation, the basic amount of EUR 25 000 must be adjusted by taking into account the applicable aggravating and mitigating factors.

539. However, no aggravating or mitigating factor is applicable regarding the infringement by the PSI of Point 3a of Section II of Annex III of the Regulation.

540. Consequently, the amount of the fine to be imposed on the PSI would amount to EUR 25 000.

#### Infringement set out at Point 3b of Section II of Annex III

541. In accordance with Article 36a(3) of the Regulation, the basic amount of EUR 25 000 must be adjusted by taking into account the applicable aggravating and mitigating factors.

542. However, no aggravating or mitigating factor is applicable regarding the infringement by the PSI of Point 3b of Section II of Annex III of the Regulation.

543. Consequently, the amount of the fine to be imposed on the PSI would amount to EUR 25 000.

#### Infringement set out at Point 4a of Section III of Annex III

544. In accordance with Article 36a(3) of the Regulation, the basic amount of EUR 90 000 must be adjusted by taking into account the applicable aggravating and mitigating factors.

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<sup>466</sup> Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”.

<sup>467</sup> Exhibit 39, PSI's Response to the IIO's Third RFI, Document “3. Scope Ratings Rating Methodologies Process Manual April 2019”, p.8: “IRF informs ESMA and Scope Rating's independent directors of the publication of new Credit Rating Methodologies and changes of Credit Rating Methodologies as well as results of the consultation, if applicable”.

545. However, no aggravating or mitigating factor is applicable regarding the infringement by the PSI of Point 4a of Section III of Annex III of the Regulation.

546. Consequently, the amount of the fine to be imposed on the PSI would amount to EUR 90 000.

#### Application of Article 36a(4) of the Regulation

547. Regarding the fines, the Board notes that Article 36a(4) of the Regulation states that “Where an act or omission of a credit rating agency constitutes more than one infringement listed in Annex III, only the higher fine calculated in accordance with paragraphs 2 and 3 and related to one of those infringements shall apply”.

548. In this respect, the Board notes that ESMA’s Supervision Department indicated the following: “In the opinion of the Supervision Department, the serious indications of the possible infringement of points 3a and 3b of Section II of Annex III and of point 4a of Section III of Annex III of the Regulation stem from the same acts and omissions. Namely, the possible fact of considering the change to the 2015 CB Methodology as being non-material is at the origin of both serious indications concerning the publication of the material change for consultation, the results of the consultation and the notification to ESMA<sup>468</sup>”. The Board notes that the IIO concurred with this position.

549. The Board agrees with ESMA’s Supervision Department and the IIO and therefore considers that Article 36a(4) of the Regulation is applicable in the present case.

550. On that basis, in accordance with Article 36a(4) of the Regulation, only the fine of EUR 90 000 related to the infringement of Point 4a of Section III of Annex III is applicable because this is the highest fine. The fines of EUR 25 000 and EUR 25 000 related respectively to the infringements of Points 3a and 3b of Section II of Annex III and constituted by the same act are thus not applicable.

551. Moreover, Article 36a(4) of the Regulation provides that “Notwithstanding paragraphs 2 and 3 [of Article 36a], the fine shall not exceed 20% of the annual turnover of the credit rating agency concerned in the preceding business year”. A fine of EUR 90 000 does not reach this 20% turnover cap.

552. Finally, Article 36a(4) of the Regulation also provides that “where the credit rating agency has directly or indirectly benefitted financially from the infringement, the fine shall be at least equal to that financial benefit”.

553. In this respect, it should be noted that in response to a request to provide the revenues received by the PSI for having issued CB ratings from 2015 to 2017, the PSI indicated that its revenues for having issued CB ratings (both public and private) amounted to EUR 155

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<sup>468</sup> Exhibit 1, ESMA/2018/14 Supervisory Report, paragraph 301.



000 under the 2015 CB Methodology, EUR 302 5000 under the 2016 CB Methodology and EUR 302 500 under the 2017 CB Methodology<sup>469</sup>.

554. However, the Board does not consider that these revenues derive, even indirectly, from the infringements of Points 3a and 3b of Section II of Annex III and of Point 4a of Section III of Annex III of the Regulation regarding the material changes to the 2015 CB Methodology. Therefore, the mentioned provision of Article 36a(4) of the Regulation regarding the financial benefit is not applicable.

### **Conclusion**

555. Consequently, the amount of the fine to be imposed on the PSI regarding the infringements related to material changes to the 2015 CB Methodology amounts to EUR 90 000.

### **Supervisory measure**

556. Regard must be had to Article 24, paragraphs 1 and 2, of the Regulation.

557. Given the factual findings in the present case, only the supervisory measure set out in Article 24(1)(e) of the Regulation may be considered appropriate with regard to the nature and the seriousness of the infringements.

558. It must thus be held that the issue of a public notice would be the only proportionate supervisory action.

## **Conclusions**

559. This Statement of Findings of the Board concludes that the PSI negligently committed the following infringements:

- Infringement set out at Point 43 of Section I of Annex III of the Regulation (by not having applied the 2015 CB Methodology in a systematic way);
- Infringement set out at Point 3a of Section II of Annex III of the Regulation (by not having notified ESMA of the intended material changes to the 2015 CB Methodology);
- Infringement set out at Point 3b of Section II of Annex III of the Regulation (by not having published on its website the proposed material changes to the 2015 CB Methodology);

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<sup>469</sup> Exhibit 11, PSI's Response to the IIO's First RFI, Question 38.

- Infringement set out at Point 4a of Section III of Annex III of the Regulation (by not having informed ESMA and not having published immediately on its website the results of a consultation about the 2015 CB Methodology).

560. The basic amount of the fine has been calculated pursuant to Article 36a) of the Regulation, which, *inter alia*, takes into account the size of the CRA.

561. In addition, for the infringement set out at Point 43 of Section I of Annex III of the Regulation, the Board has applied the relevant aggravating and mitigating factors prescribed by Annex IV of the Regulation. Therefore, the fine to be imposed for the infringement set out at Point 43 of Section I of Annex III of the Regulation amounts to EUR 550 000.

562. Furthermore, the Board considers that the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III are constituted by the same act. In accordance with Article 36a(4) of the Regulation, only the highest fine of EUR 90 000 related to the infringement of Point 4a of Section III of Annex III is applicable in this case regarding these three infringements.

563. Therefore, the overall fine to be imposed on the PSI for having negligently committed the four infringements amounts to EUR 640 000 (EUR 550 000 + EUR 90 000).

564. Finally, the infringements require the adoption of a supervisory measure taking the form of a public notice concerning the PSI.

## Annex 1 - Unsolicited ratings of 22 September 2015

Country	Covered bond issuer (or parent)	ICSR (Long term/ Outlook/ Short term)	Covered program/ bond type	Fundamental uplift	Cover Pool uplift	Combined CB uplift	CB Rating (Long term/ Outlook )	Rating buffer
Denmark	Danske Bank A/S	A- /Stable /S-1	Pool C - SDO	6	N/A	6	AAA/ Stable	0
			Pool D - SDO		N/A		AAA/ Stable	0
			Pool I - SDO		N/A		AAA/ Stable	0
France	BNP Paribas SA	A+ /Negative /S-1	BNP Paribas Home Loan SFH (Obligation d'habitat)	6	N/A	6	AAA/ Stable	2
			BNP Paribas Public Sector SCF (Obligation foncières)	6	N/A	6	AAA/ Stable	2
	BPCE SA	A+ /Stable /S-1	BPCE SFH (Obligation d'habitat)	6	N/A	6	AAA/ Stable	2
	Credit Agricole Group	A /Positive /S-1	Credit Agricole Home Loan SFH (Obligation d'habitat)	6	N/A	6	AAA/ Stable	1
			Credit Agricole Public Sector SCF (Obligation foncières)	6	N/A	6	AAA/ Stable	1
	Societe Generale SA	A /Stable /S-1	Société Générale SFH (Obligation d'habitat)	6	N/A	6	AAA/ Stable	1
			Société Générale SCF (Obligation foncières)	6	N/A	6	AAA/ Stable	1
Germany	Commerzbank AG	A- /Stable /S-1	Öffentliche Pfandbriefe	6	N/A	6	AAA/ Stable	0
			Hypothekendarlehen	6	N/A	6	AAA/ Stable	0

	Deutsche Bank AG	A- /Stable /S-1	Hypothekendarlehen	6	N/A	6	AAA/ Stable	0
Spain	Banco Santander SA	A+ /Stable /S-1	Cédulas Hipotecarias	6	N/A	6	AAA/ Stable	2
			Cédulas Territoriales	5	N/A	6	AAA/ Stable	1
	BBVA SA	A /Stable /S-1	Cédulas Hipotecarias	6	N/A	6	AAA/ Stable	1
			Cédulas Territoriales	5	N/A	6	AAA/ Stable	0

*Based on the figures provided by the PSI in a Credit Rating Memorandum of 17 September 2015<sup>470</sup>*

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<sup>470</sup> Supervisory Report, Exhibit 3, 2015-09-23 Scope Assigns Unsolicited Covered Bond Ratings to 9 issuers- v3, pp. 1-2.

## Annex 2 - Unsolicited ratings of 26 November 2015

Country	Covered bond issuer (or parent)	ICSR (Long term/ Outlook/ Short term)	Covered program/ bond type	Fundamental uplift	Cover Pool uplift	Combined CB uplift	CB Rating (Long term/ Outlook)	Rating buffer
Sweden	Nordea Bank AB	A+ /Stable /S-1	Nordea Hypotek AB/ Säkerställda obligationer	6	N/A	6	AAA/ Stable	2
	Svenska Handelsbanken AB	A- /Stable /S-1	Stadshypotek AB/ Säkerställda obligationer	6	N/A	6	AAA/ Stable	1
	Swedbank AB	A- /Stable /S-1	Swedbank Hypotek AB/ Säkerställda obligationern (SE)	6	N/A	6	AAA/ Stable	0
			Swedbank Hypotek AB/ Säkerställda obligationer (NO)	6	N/A	6	AAA/ Stable	0

Based on the figure provided by the PSI in a Credit Rating Memorandum of 24 November 2015<sup>471</sup>

<sup>471</sup> Supervisory Report, Exhibit 74, 20151124 Swedish CBs Unsolicited CB Ratings - Rating Memo for CMT, p.4.

## Annex II

### Public Notice

**Scope Ratings GmbH** (formerly Scope Ratings AG – from now on ‘Scope’) is a German-based credit rating agency (CRA), registered since 24 May 2011, with branch offices in the UK, Italy, France and Norway.

Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (‘the Regulation’) lays down obligations for CRAs in the conduct of their activities. In conjunction with its role of supervisor of CRAs under Article 21 of the Regulation, the European Securities and Markets Authority (‘ESMA’) has functions and powers to take enforcement actions in relation to infringements of the Regulation by CRAs.

According to the Article 8(3) of the Regulation, the CRAs shall use rating methodologies that are systematic. The provision is supplemented by Article 5(1) of the Delegated Regulation No 447/2012, that further clarifies that the CRAs shall use credit rating methodologies which are applied systematically in the formulation of all credit ratings in a given asset class or market segment unless there is an objective reason for diverging from the established methodology. Pursuant to Article 2 of the Delegated Regulation, the CRAs shall at all times be able to demonstrate to ESMA the compliance with the requirements set in Article 8(3) of the Regulation.

Moreover, according to Article 8(5)(a), Article 8(6)(aa), Article 8(6)(ab) and Article 14(3) third subparagraph of the Regulation, when a CRA intends to make material changes to any of its rating methodologies, it must publish the proposed material changes on its website, inviting stakeholders to submit comments for a period of one month, together with a detailed explanation of the reasons for and the implications of the proposed material changes. The CRA must also notify ESMA of the intended material changes to the rating methodology. After the expiry of the consultation period, the CRA shall inform ESMA about the results of the consultation and publish them on its website (including the individual responses). Finally, the CRA shall notify ESMA of any changes to the methodology due to the consultation.

In 2018, ESMA’s Supervisory Department concluded, following preliminary investigations, that with respect to Scope there were serious indications of the possible existence of facts liable to constitute one or more of the infringements listed in Annex III to Regulation (EC) No 1060/2009.

The matter was then referred to an Independent Investigating Officer (‘the IIO’) who, after having conducted an investigation, submitted her findings to the Board of Supervisors (‘the Board’).



Having considered the evidence, the Board of Supervisors has found that Scope negligently committed the following infringements of the Regulation.

### **First Infringement**

Scope negligently committed the infringement set out at Point 43 of Section I of Annex III of the Regulation (by not having applied the 2015 CB Methodology in a systematic way).

#### **A) Relevant legal provisions**

CRA Regulation

Article 8 (*Methodologies, models and key rating assumptions*)

Para. 3. *A credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.*

Delegated Regulation (EU) No 447/2012

Article 2 (*Demonstration of compliance*)

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

Article 5 (*Assessing that a credit rating methodology is systematic*)

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

Annex III - *List of infringements referred to in Article 24(1) and Article 36a(1)*

Section I - *Infringements related to conflicts of interest, organisational or operational requirements*

Point 43. *The credit rating agency infringes Article 8(3) by not using rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.*

## **B) Factual findings and analysis of the Board**

In 2015, Scope adopted a Covered Bond Methodology, which foresaw, in addition to an analysis of the issuer credit strength, an analysis constituted of two further elements: the first building block consisted of the analysis of the legal framework and the resolution regime, whereas the second building block consisted of the analysis of the cover pool. The 2015 Covered Bond Methodology also specified that a thorough analysis of the cover pool had to be performed for all rated covered bonds.

The 2015 Covered Bond Methodology was applied by Scope for issuing ratings to 17 covered bond programmes, which amounted to a total of 622 ratings. The cover pool was only analysed in two of these covered bond programmes. On the contrary, the ratings issued in September and November 2015 did not comprise the type of analysis of the cover pool which was foreseen by the 2015 Covered Bond Methodology.

The Board therefore found that the 2015 Covered Bond Methodology was not applied systematically. In addition, the Board found that there were no objective reasons for divergence from the systematic application of the 2015 Covered Bond Methodology.

Furthermore, the Board noted that the ratings without the foreseen cover pool analysis constitute 559 ratings out of the 622 ratings which were assigned on the basis of the 2015 Covered Bond Methodology, i.e. they were not an exception.

## **C) Finding of the infringement**

On the basis of the assessment of the complete file submitted by the IIO and of the arguments raised in the written submissions, the Board found that Scope failed to comply with the requirements of Articles 8(3) of the Regulation as supplemented by Article 5(1) of the Delegated Regulation No 447/2012 and thus committed the infringement set out at Point 43 of Section I of Annex III, of the Regulation.

Furthermore, the Board found that Scope did not meet the special care expected from a CRA as a professional firm in the financial services sector. Therefore, the Board found that Scope had committed the infringement negligently and was liable to a fine.

The basic amount of the fine was calculated pursuant to Article 36a) of the Regulation, which, *inter alia*, takes into account the size of the CRA. In addition, the Board applied the relevant aggravating and mitigating factors prescribed by Annex IV of the Regulation and therefore fined Scope EUR 550 000.

## **D) Supervisory measure and fine**

### **Public notice**

Pursuant to Article 24 of the Regulation, the Board decided that the infringements warranted a supervisory measure in the form of the publication of this public notice.

## **Fine**

The fine imposed on Scope Ratings GmbH is EUR 550 000.

## **Second set of Infringements**

Scope negligently committed the infringements set out at: Point 3a of Section II of Annex III of the Regulation (by not having notified ESMA of the intended material changes to the 2015 CB Methodology); Point 3b of Section II of Annex III of the Regulation (by not having published on its website the proposed material changes to the 2015 CB Methodology); Point 4a of Section III of Annex III of the Regulation (by not having informed ESMA and not having published immediately on its website the results of a consultation about the 2015 CB Methodology).

## **B) Relevant legal provisions**

CRA Regulation

Article 8 (*Methodologies, models and key rating assumptions*)

*Para. 5a. A credit rating agency that intends to make a material change to, or use, new rating methodologies, models or key rating assumptions which could have an impact on a credit rating shall publish the proposed material changes or proposed new rating methodologies on its website inviting stakeholders to submit comments for a period of one month together with a detailed explanation of the reasons for and the implications of the proposed material changes or proposed new rating methodologies.*

Article 8 (*Methodologies, models and key rating assumptions*)

*Para. 6 Where rating methodologies, models or key rating assumptions used in credit rating activities are changed in accordance with Art. 14(3), a credit rating agency shall:*

*(aa) immediately inform ESMA and publish on its website the results of the consultation and the new rating methodologies together with a detailed explanation thereof and their date of application;*

*(ab) immediately publish on its website the responses to the consultation referred to in paragraph 5a except in cases where confidentiality is requested by the respondent to the consultation; (...)."*

Article 14 (*Requirement for registration*)

*Para. 3 (3) Without prejudice to the second subparagraph, the credit rating agency shall notify ESMA of the intended material changes to the rating methodologies, models or key rating assumptions or the proposed new rating methodologies, models or key rating*

*assumptions when the credit rating agency publishes the proposed changes or proposed new rating methodologies on its website in accordance with Article 8(5a). After the expiry of the consultation period, the credit rating agency shall notify ESMA of any changes due to the consultation.*

*Annex III - List of infringements referred to in Article 24(1) and Article 36a(1)*

*Section II - Infringements related to obstacles to the supervisory activities*

*Point 3a. The credit rating agency infringes the third subparagraph of Article 14(3) by not notifying ESMA of the intended material changes to the existing rating methodologies, models or key rating assumptions or of the proposed new rating methodologies, models or key rating assumptions when it publishes the rating methodologies on its website in accordance with Article 8(5a).*

*Point 3b. The credit rating agency infringes the first subparagraph of Article 8(5a) by not publishing on its website the proposed new rating methodologies or the proposed material changes to the rating methodologies that could have an impact on a credit rating together with an explanation of the reasons for and the implications of the changes.*

*Section III - Infringements related to disclosure provisions*

*Point 4a. The credit rating agency infringes point (aa) of Article 8(6), where it intends to use new rating methodologies, by not informing ESMA or by not publishing immediately on its website the results of the consultation and those new rating methodologies together with a detailed explanation thereof and their date of application.*

## **B) Factual findings and analysis of the Board**

In 2016, Scope introduced changes to its 2015 Covered Bond Methodology.

However, Scope did not publish on its website the proposed material changes and did not invite stakeholders to submit comments for a period of one month; it was therefore unable to publish on its website the results of this consultation; it also did not notify ESMA of the intended material changes at the time of the consultation and did not notify ESMA of changes due to this consultation.

The Board found that the changes introduced in 2016 to the 2015 Covered Bond Methodology were material, because they modified the way in which an assessment of the cover pool had to be performed under this methodology.

## **C) Finding of the infringement**

On the basis of the assessment of the complete file submitted by the IIO and of the arguments raised in the written submissions, the Board found that Scope failed to comply with the requirements of Articles 8(5a), 8(6) (aa) and 14(3) third subparagraph of the

Regulation, and thus it committed the infringements set out at Point 3b of Section II of Annex III, Point 4a of Section III of Annex III, Point 3a of Section II of Annex III.

Furthermore, the Board found that Scope did not meet the special care expected from a CRA as a professional firm in the financial services sector. Therefore, the Board found that Scope had committed the infringement negligently and was liable to a fine.

The basic amount of the fine was calculated pursuant to Article 36a) of the Regulation, which, *inter alia*, takes into account the size of the CRA. Therefore:

- i) the fine to be imposed for the negligent infringement set out at Point 3a of Section II of Annex III of the Regulation amounts to EUR 25 000 (there being no applicable aggravating or mitigating factors).
- ii) The fine to be imposed for the negligent infringement set out at Point 3b of Section II of Annex III of the Regulation amounts to EUR 25 000 (there being no applicable aggravating or mitigating factors).
- iii) The fine to be imposed for the negligent infringement set out at Point 4a of Section III of Annex III of the Regulation amounts to EUR 90 000 (there being no applicable aggravating or mitigating factors).

Nevertheless, the Board considered that the infringements of Points 3a and 3b of Section II of Annex III and Point 4a of Section III of Annex III stem by the same act. In accordance with Article 36a(4) of the Regulation, only the highest fine of EUR 90 000 related to the infringement of Point 4a of Section III of Annex III is applicable in this investigation regarding these three infringements.

#### **D) Supervisory measure and fine**

##### **Public notice**

Pursuant to Article 24 of the Regulation, the Board decided that the infringements warranted a supervisory measure in the form of the publication of this public notice.

##### **Fine**

The fine imposed on Scope Ratings GmbH is EUR 90 000.

##### **Overall fine**

The overall fine to be imposed on Scope Ratings GmbH for four infringements committed with negligence amount to EUR 640 000 (EUR 550 000 + EUR 90 000).