FINANCIAL CONDUCT AUTHORITY

12 Endeavour Square
London
E20 1JN

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

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This letter is historical. See our supervisory correspondence page for more information and current views.

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Dear CEO,

This is the first FCA portfolio letter for credit rating agencies (CRAs). We are sending it to all firms in the portfolio to communicate what we expect CRAs to do to minimise risks to consumers, market integrity or competition from failures to meet regulatory requirements. We also set out key elements of what we will be doing to supervise firms in the portfolio.

We supervise CRAs according to the EU Credit Rating Agencies Regulation as amended by the CRA Regulations (EU Exit) 2019 (referred to collectively as the 'CRA Regulation'). It is important that you understand our approach to supervising your firm, your responsibility to act in accordance with the requirements of the CRA Regulation, and that you can demonstrate this to us. First and foremost, we expect you to adopt an open and cooperative relationship with us.

In line with the FCA's Approach to Supervision, we take a holistic approach to supervising this portfolio and therefore if your firm or the group to which your firm belongs also undertakes unregulated activities, we may assess these unregulated activities as part of our supervision of the regulated activities.

Our supervision approach

In accordance with the CRA Regulation, credit rating activities must be conducted in keeping with the principles of integrity, transparency, responsibility, good governance and independence. To deliver on these principles, we expect all firms to have a sound governance and oversight framework, suited to the size and nature of your operations, which focuses on the delivery of independent and high quality ratings and methodologies by capable staff, using robust systems.

While regulatory and mechanistic reliance on credit ratings may have decreased since the global financial crisis, the lack of readily available alternatives to ratings means that they remain systemically important and embedded in capital markets. Regardless of whether you have an issuer or investor pays business model, you must demonstrate your ability to effectively manage potential conflicts of interest that are to different degrees inherent in your business.

Activities outside the regulatory perimeter may also impact credit rating activities and you must demonstrate that you have considered and are actively managing potential risks.

Our data strategy is a core component of our supervision strategy, and we will identify potential and actual risks of harm by reviewing regulatory reporting submitted by you, alongside other key risk indicators. We will enforce in line with the FCA's Approach to Enforcement where appropriate, with real and meaningful consequences for firms who don't follow the rules.

Our supervisory priorities

You should consider the risks outlined below with regards to your business, how you monitor these risks and whether you have appropriate strategies in place to address them.

Ratings process and methodologies

Our view of the risks

We consider the quality of the ratings process, quality of methodologies and adequacy of disclosures as the primary drivers of the independence and accuracy of credit ratings. Our supervision approach focuses on the application of your processes and their outcome.

We observe the current standard of regulatory notifications by firms (e.g. identification of errors in methodologies / model processes; actual or potential breaches of the CRA Regulation) is inconsistent in terms of timeliness and meaningful content. Further, we see in some firms a level of reported errors and breaches which may indicate deficiencies of a more serious nature. If ratings are assigned in a manner that compromises their quality, this may lead to significant or unexpected ratings transition or withdrawals, with consequent risks to market confidence and integrity. Methodologies, inclusive of models and key rating assumptions, are fundamental to the assignment of credit ratings. These must be rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing. Errors in your methodologies or their application, and biases in the methodology development process could negatively affect the quality and integrity of the output. We observe some instances where the rationale for methodology updates and changes to the review process lack detail and transparency. This could lead to the risk that ratings are not accurate or independent indicators of creditworthiness, leading to substandard quality and potential market disruptions.

What we expect from you

Addressing any weaknesses in your ratings process and methodologies should be your priority. We expect you to meet your obligation for regulatory notifications on a timely basis with the appropriate level of detail. You should therefore review your policies and procedures for regulatory notifications to ensure you are fulfilling these requirements. Where there are errors in your methodologies or processes and breaches of the CRA Regulation, you should conduct analysis to assess root cause and take corrective actions. We expect you to document clearly your ratings process and to explain thoroughly the key risk factors considered when assigning ratings. We expect you to mitigate any conflicts of interest in your methodology development and review processes, and disclose with a clear rationale any updates to your methodologies or processes. To the extent that you incorrectly apply your methodologies and ratings process, we expect you to inform us of these errors and the actions taken to correct them.

What we will do

We will review regulatory notifications that you send to us to check that you are actively identifying potential errors and breaches and reporting them according to the CRA Regulation. We will undertake spot checks which may include targeted reviews of rating actions, methodology updates, and the process leading to methodology changes. We will supervise your management of these risks, including through engagement with you, and take action against firms that fall short of our expectations.

<u>Governance and oversight</u>

Our view of the risks

Sound governance, both its effectiveness and design, is at the heart of quality ratings. Our supervision approach focuses on your conduct risk framework, whether you have effective governance arrangements in place to identify the risk of harm to consumers and markets, and whether you have a strategy in place to manage and mitigate those risks. In particular, the CRA Regulation requires that senior management is of good repute, sufficiently skilled and experienced to ensure the sound and prudent management of the firm.

For this portfolio, we observe varying levels of board effectiveness and we have concerns about the robustness of risk frameworks given the nature of global group structures and the use of resources outside the UK. If board governance is not sufficiently strong or board level accountability is not clear, if there are gaps in oversight and independent challenge or weak internal control frameworks, the risk of low quality ratings will be high.

What we expect from you

We expect you to exhibit sound governance through effective board oversight and an internal controls structure to ensure an independent ratings process and methodologies that are free from conflicts of interest. Where your firm is using non-UK based resources to deliver any aspect of your internal controls framework and/or process for issuing credit ratings, we expect you to implement governance and control arrangements to oversee these activities. We expect you to assess the skills of your senior management against the requirements of the CRA Regulation and to demonstrate the standard is met.

What we will do

We will assess the effectiveness of board oversight which will include reviewing board documentation and meeting with selected board members. We will assess your internal controls structure, including its reliance on and oversight of non-UK based staff and arrangements, and senior management skills. We will challenge you and expect improvements if you are unable to demonstrate adequate oversight.

<u>Market and perimeter risks</u>

Our view of the risks

The FCA-regulated CRA portfolio reflects the global industry, which is concentrated among a small number of large firms. Whilst smaller CRAs may not have the profile or resources of their larger competitors, they have an important role to play in financial markets by providing alternative opinions and in some cases specialist sector knowledge. Smaller firms must also invest sufficiently in people, processes and systems to ensure the quality of their credit rating activities.

CRAs are increasingly active outside of the regulatory perimeter through provision of a variety of unregulated data, research and analytics (e.g. credit assessments and cyber risk ratings) beyond regulated credit ratings. As CRAs expand these product offerings, this may introduce conflicts of interest which, if not identified and managed, could impact the quality and independence of regulated credit rating activities.

Environmental, Social and Governance (ESG) is a growing area of focus across the portfolio, with increasing investor focus on ESG risk factors and some firms expanding their product offerings to include ESG ratings, scores and data. For those products which are not credit ratings and sit outside of our current regulatory remit, it is important that CRAs make this distinction clear to prevent investor confusion. Further, where CRAs are sharing resource and data across the regulatory perimeter, there should be appropriate governance arrangements and management of conflicts of interest.

What we expect from you

We expect all firms, regardless of organisation structure and size to meet the requirements of the CRA Regulation. Given the fast pace of development of significant unregulated activities and the potential conflicts of interest with the regulated activities, we expect you to put in place robust governance arrangements and oversee the interactions between regulated and unregulated activities (e.g. ESG ratings). Further, for credit ratings, we expect you to disclose ESG risk factors according to your methodologies.

What we will do

To promote competition in the interests of the market, we will publish a market share report for UK registered CRAs. We will be proactive at the boundaries of our regulatory perimeter, especially where unregulated activities may impact regulated activities. We will assess areas outside the regulatory perimeter to the extent they may impact credit ratings, or we consider there is potential risk.

<u>Operational resilience and resourcing</u>

Our view of the risks

Operational resilience is key for all FCA-regulated firms as disruptions can cause harm to consumers and, for some firms, may risk market integrity. For CRAs in particular, failure to provide timely and accurate credit ratings could result in misinformation and potential inappropriate allocation of capital. Given the dependence on technology, market disruption may occur if key systems or tools integral to the ratings process are not functioning or compromised. We have observed cases where firms did not understand their obligation to inform us of information security incidents.

Many firms have a growing reliance on insourcing aspects of the ratings process to affiliated group entities and/or outsourcing to third party providers. Where a firm operates this model, the robustness of your processes and internal controls framework must be maintained. We observe a lack of visibility of how these arrangements are being managed and assessed for additional risks.

Further, in light of the challenging working environment due to the pandemic, organisational changes following Brexit and competitive dynamics of the market, we note instances of actual or potential key person dependencies and difficulties to attract or retain analytical staff. Where resourcing constraints are not addressed, ratings may suffer in quality. The assignment of new ratings should not have a negative impact on your capability and obligation to maintain the accuracy of existing ratings through your surveillance process.

What we expect from you

We expect you to be operationally resilient against multiple forms of disruption and to address the root cause for repeated incidents – this applies to larger and smaller firms. Where disruption does occur, you should notify us accordingly and we expect you to have robust and quick-to-implement alternative arrangements which you test regularly. We expect your insourcing and outsourcing arrangements to consist of robust systems and processes, and skilled people. For these operations, you must be able to identify and mitigate any related risks, and effectively monitor these through your internal controls. Where there are failings, we expect you to contact us immediately, and describe your plans to remedy these. Regarding your resourcing to deliver credit rating activities, we expect you to assess your requirements and ensure that your analytical staff have the appropriate knowledge, experience and capacity to deliver high quality ratings and monitor these on an ongoing basis.

What we will do

Where there is a material operational incident, we will engage with you to understand the cause and the effectiveness of the remedies. If you fail to inform us, we may take regulatory action. We will provide feedback later in the year to those firms who have responded to our operational resilience and cyber questionnaires. We will review your monitoring of resourcing arrangements to evaluate if availability and capability standards are met.

Other areas of work impacting the portfolio

This letter does not provide an exhaustive list of the risks to consumers, market integrity or competition that CRAs could create if they fail to meet regulatory requirements. Nor is it an exhaustive list of the work that we intend to undertake. Our supervision priorities may change to reflect the evolving nature of your business and markets, and our view of the potential risks.

Here are other priority areas where the FCA will be undertaking work relevant to the CRA portfolio.

Accessing and using wholesale data - We announced that we will undertake a market study looking at competition in the sale of credit rating data. The study will look at issues such as pricing and contractual relationships, barriers to entry and the scope for and level of innovation. We plan to launch the market study by the end of 2022 and will publish more details of the scope and timetable at that time.

ESG ratings – In 2021, the Government published a roadmap, Greening Finance: A Roadmap to Sustainable Investing, setting out plans for sustainable finance policy, including potential regulation of ESG data and ratings providers. We will continue our engagement with HM Treasury (HMT) on this topic. Following our consultation paper on enhancing climate related disclosures by standard listed companies (CP21/18), we will publish a feedback statement on topics covered in the discussion chapter of that consultation, including ESG data and ratings providers, in the first half of 2022.

Senior Managers and Certification Regime (SM&CR) - The SM&CR aims to reduce harm to consumers and strengthen market integrity by improving conduct at all levels within firms and enhancing senior management accountability. While SM&CR does not currently apply to CRAs, we have made public in the Perimeter Report 2020/2021 our view that we would like to extend it to this portfolio, and are discussing this with HMT.

Our overall expectation of the firms

Firms in this portfolio are new to FCA regulation. We remind you that you must disclose to the FCA appropriately anything relating to the firm of which we would reasonably expect notice. That means taking the initiative in doing so, as well as responding to our questions, in an open and timely manner. Firms are responsible for ensuring that they understand the CRA Regulation and comply with them.

You should consider the issues in this letter, and how you have ensured that you have addressed them.

Next steps

Should you have any queries about this letter, please contact us on Creditratingagencies@fca.org.uk. This is the primary contact for your firm’s day-to-day interactions with the FCA.

We recognise there may be occasions when your firm faces urgent issues of strategic importance. In such circumstances, please contact Irene Ho-Moore, Credit Rating Agencies Supervision on Creditratingagencies@fca.org.uk.

Yours faithfully

Edwin Schooling Latter

Director of Markets and Wholesale Policy and Wholesale Supervision
Financial Conduct Authority