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Dear chief executive,

Our supervisory strategy for credit rating agencies

This is our second letter to the portfolio of credit rating agencies (CRAs) we supervise, the first [letter](#) having been sent in February 2022 (portfolio letter). We also issued a Dear CEO [letter](#) on governance in October 2022 (governance letter). This letter provides our view of the key risks in this sector, our expectations of you and a summary of the work we intend to do over the next two years.

We have seen some progress by CRAs in response to the risks identified in our previous letters, with more to be done particularly in the areas this letter highlights. We expect your board to play a key role in the oversight and consideration of these risks including any actions to address them. As outlined in our governance letter, we consider a strong governance framework essential to ensuring your firm delivers quality and independent ratings.

To deliver on these outcomes, we value an open and cooperative relationship with you. This includes disclosing information to us appropriately and taking the initiative to do so in a timely manner.

Our overall supervisory strategy for CRAs continues to be particularly driven by the following considerations:

- **Conflicts of interest** - potential conflicts of interest remain inherent in the CRA business model, whether a firm has an issuer- or investor-pays business model. You must demonstrate that you are able to identify and manage effectively existing or potential conflicts of interest to ensure the delivery of high-quality and independent ratings.
- **Location of activities** - many UK-regulated CRAs operate within group structures involving multiple offices in different regions and complex outsourcing arrangements. The reliance on non-UK based operations can be across a wide range of business areas including analytical resourcing, internal controls, systems, senior management and governance. You must demonstrate your ability to identify, manage and oversee these dependencies for the UK regulated entity, including by ensuring you have in place clear roles, responsibilities and accountabilities.

- **Impact on financial markets** - poor quality ratings could have an impact on wider market integrity through the misallocation of capital and/or suboptimal credit decisions. We recognise that the role of CRAs continues to evolve as financial markets see the value of credit opinions in new rating sectors or unregulated activities. It is also possible that credit conditions could change quickly, testing your ability to monitor ratings. You must demonstrate that ensuring the quality and independence of the core ratings business is your key regulatory priority.
- **Innovation within CRAs** - we see CRAs exploring new technology capabilities and developing new opportunities to enhance their rating processes, and systems and controls. The FCA recognises the potential benefits of innovation and is keen to understand how CRAs are using new technology and managing the associated risks.

Our key supervisory priorities over the coming period

1. Governance and oversight

Our view of the risks

CRAs should have a sound governance framework comprising an effective board, senior leadership accountability and robust internal controls to deliver the outcome of effective oversight of credit rating activities with conflicts of interest mitigated. We wrote to CEOs in October 2022 and have been pleased to see firms respond constructively to our letter, putting in place action plans to address those areas that fell below expectations. Still, more can be done to demonstrate sufficient oversight of the UK regulated entity.

We have engaged directly with your internal control functions and reviewed their outputs. Given UK CRAs continue to rely on global group operations, we have ongoing concerns about your visibility of non-UK interdependencies and whether your control frameworks are robust enough to oversee and mitigate the risks.

What we expect from you

Governance - we expect you to have implemented and put into practice the expectations outlined in our governance letter and where there are still actions to be taken, that these are addressed without delay. With a UK board framework in place, we expect you to demonstrate its effectiveness in overseeing your firm's compliance with the CRA Regulation, how the UK regulated entity operates as part of a global structure and how its strategy fits within the global organisation. In particular, we expect you to evidence your oversight of the issues outlined in this letter. This includes clear management information to the board and evidence of challenge and influence, including that of independent non-executive directors.

Oversight - we expect your internal control arrangements to robustly monitor the activities of the UK regulated entity, including risks arising from use of non-UK staff and operations. Further, we expect to see evidence of reporting to the board of clear metrics and risk assessments, any actions you are taking and evidence of

board oversight of such actions. Should your firm expand to new business areas, we expect the control environment to take this into account.

What we will do

We will follow up with your board on our governance letter to assess the extent of action plans that were put in place. We will assess the effectiveness of your board and internal control structures through how you evidence your oversight of the quality of ratings and methodologies, and operational resilience, any failings and related improvements, and how you monitor outcomes.

2. Ratings process and methodologies

Our view of the risks

Given the potential conflicts of interest inherent in the CRA business model, the principle of independence must be upheld in individual ratings and their methodologies. Ratings that lack quality and independence may not reflect methodologies and could be at more risk of unexpected rating actions. Sudden and unexpected multi-notch changes, in particular downgrades may impact market confidence, resulting in loss of market integrity and financial loss to investors. Methodologies and models provide the basis for quality ratings.

Within some CRAs we observed differences in the ratings process for new ratings and surveillance of current ratings. These include the depth of analysis undertaken, documentation to support a rating action, and use of analytical tools and their controls. While review processes may exist in the form of a second person review or committee discussion, we noted errors leading to incorrect outcomes. For some firms, we observed limited evidence of challenge or review by control functions.

The standard of regulatory notifications continues to vary across the portfolio. While we have seen some improvement since our last portfolio letter, we continue to observe delays in reporting and lack of detail.

What we expect from you

Regarding risks related to ratings process and methodologies, we expect the board to ensure compliance with the CRA Regulation. In particular, we expect to see improved evidence of oversight from internal control structures, senior management and the board, with a particular focus on the following areas:

- **Ratings process** – implementation of quality first line end-to-end ratings processes with strong second and third line controls. We expect you to maintain adequate internal records to document the basis of your rating opinions and disclose adequately and accurately the rationale for your rating actions, including Environmental, Social and Governance (ESG) risk factors. We expect you to ensure the quality of credit ratings on an ongoing basis through your surveillance process. You should therefore ensure you meet the CRA Regulation for both new and current ratings. For significant rating transitions, you should review them to understand the root cause and what actions, if any are required.

- **Adequate resources** – recruitment and retention of knowledgeable and experienced analytical resources. This includes evidence of how you are assessing the impact of staff departures on your ability to issue, monitor and update ratings given evolving market and credit conditions.
- **Methodology development and review** – implementation of a development and review process that ensures methodologies are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing. This should include the appropriate documentation and disclosure.
- **Regulatory reporting** – submission of quality regulatory reporting in a timely manner. You should conduct root cause analysis of errors and breaches and identify any thematic issues. You should take complete and corrective actions without delay.

What we will do

We will engage with you to assess your end-to-end ratings and methodology processes. We will seek evidence of meaningful board oversight and improved outcomes including, but not limited to, adequacy of disclosures, oversight of outlier rating actions, and findings from regulatory reporting.

3. Operational resilience

Our view of the risks

In the operational resilience questionnaires (known as ORQuest) completed by CRAs over the past two years, some CRAs self-identified shortcomings persisting in multiple areas, such as incident management, change management, service continuity and testing, risk management and third-party management.

We observed descriptions of weak business continuity and disaster recovery practices as well as varying levels of understanding of technology and cyber risks in some firms. We also saw limited second line oversight over technology and cyber, with at times no dedicated resources in this area for some CRAs. There was generally a lack of review by control functions of UK specific technology and cyber risks. Some technology incidents were not reported in a timely manner or at all. For some CRAs relying on parent companies or external third parties for technology and cyber services, we observed under-developed third-party management frameworks. We saw limited oversight of data centres and group-wide technology projects supporting the UK regulated entity. There was limited evidence of the risk of outsourced activities being reviewed comprehensively by the board, with insufficient information on service level agreements (SLAs) and how those were being monitored.

What we expect from you

Regarding risks related to operational resilience, we expect the board to ensure compliance with the CRA Regulation. We expect your board and senior management to consider, if fit for your operating environment, the following:

- **ORQuest** – where you have identified weaknesses, you should consider putting in place an action plan that is proportionate to your business model and activities to ensure your continuous compliance with CRA Regulation.
- **Risk and controls** – whether you have clear identification of your critical technology and cyber controls that you rely on, including those provided by third parties and how you manage the risks of these arrangements.
- **Resources and capabilities** – whether you have adequate technology and cyber expertise and capability.
- **Outsourcing** – whether you have a robust understanding and oversight of all outsourced activities, and risk and controls including SLAs and metrics.
- **Reporting** – we expect to see an improvement in the quality and timeliness of technology incident reporting, including root cause analysis and steps taken to prevent re-occurrence. Further, we expect resolution times to be proportionate to the risk, which means more timely action in certain cases.

While the FCA's [PS21/3 Operational Resilience](#) does not apply directly to CRAs, we suggest you consider it for suggestions on how to improve operational resilience.

What we will do

We will engage with you to understand the actions you have taken to strengthen operational resilience within your firm, including providing us with an action plan where appropriate. We will assess the extent of your oversight of outsourced activities, including metrics provided to the board. We will issue a cyber questionnaire and engage with you on our broader operational resilience agenda.

Other areas of focus relevant to the portfolio

In addition, the FCA will be undertaking other work relevant to the CRA portfolio.

Market and perimeter considerations

Competition

One of the aims of the CRA Regulation is to increase competition among CRAs by encouraging the use of smaller CRAs through the application of Article 8d. This states that where issuers or related third parties intend to use 2 or more CRAs, they should consider appointing at least one with no more than 10% of the total market share. Where an issuer or related third party does not do this, they should document that decision. As part of our supervisory work, we want to better understand the effectiveness of Article 8d in promoting competition among CRAs.

Unregulated activities

CRAs continue to be active outside the regulatory perimeter and expand their range of unregulated product offerings, such as credit assessments and private market products. We expect CRAs to have robust governance and internal control

arrangements to ensure non-regulated activities do not impact negatively the regulated business. Where there are risks, these should be monitored and mitigated, with oversight by the board and senior management.

ESG ratings

In August 2024, the Government announced that it intends to pursue the regulation of ESG ratings, where assessments of ESG factors are used for investment decisions and influence capital allocation. We are working closely with His Majesty's Treasury as officials develop the perimeter of this future regulation and will engage with firms to help inform our thinking on developing an appropriate regulatory framework for this market.

Future review of the CRA Regulation

The Financial Services and Markets Act 2023 provides the legal basis for the repeal of assimilated law and its replacement with regulators' rules. The CRA Regulation is assimilated law that is expected to be reviewed as part of this in due course. Our supervisory findings will help to inform this review and any subsequent changes to the regulatory framework. We will continue to engage with firms including your board, advisers and other regulatory bodies as part of this.

Earlier this year, we published our [Wholesale Data Market Study report](#) containing findings on competition for credit ratings data, benchmarks and market data vendor services. This report identifies a number of issues that may limit effective competition within the credit ratings data feed market. As noted in the report, we considered that the best way to tackle these issues is to look at them holistically as part of the wider regulatory work in wholesale financial markets and alongside international developments. Where appropriate, these issues could be considered as part of the above review of the CRA Regulation whilst tackling firm specific issues using other tools such as our powers under the Competition Act 1998.

Next steps

You should consider the issues in this letter and how to ensure that you address them. We expect you to discuss the contents of this letter with your senior management team and the board and be able to demonstrate your plans to meet the expectations set out above. We would also be happy to discuss any of the contents of this letter with you, so please let us know if you would like to do that. Please contact us on Creditratingagencies@fca.org.uk. This is the primary contact for your firm's day-to-day interactions with the FCA.

Yours sincerely

Jon Relleen

Director – Infrastructure & Exchanges