



European Securities and  
Markets Authority



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JOINT COMMITTEE OF THE EUROPEAN  
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## **EBA, EIOPA and ESMA**

### **Final Report**

**On**

### **Mechanistic references to credit ratings in the ESAs' guidelines and recommendations**

**(JC 2014 004)**

London, Frankfurt, Paris 06 February 2014

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## Acronyms

EBA	European Banking Authority
ESMA	European Securities and Markets Authority
EIOPA	European Insurance and Occupational Pensions Authority
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
NCAs	national competent authorities
SCA	sectoral competent authorities
STMMF	short-term money market fund
MMF	money market fund
MFI	monetary financial institutions
SA	standardised approach

## I. Overview

### Reasons for publication

1. The new Article 5b(1) of the CRA Regulation – as amended by the CRA3 Regulation<sup>1</sup> - states that the EBA, EIOPA, and ESMA shall not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities, the entities referred to in the first subparagraph of Article 4(1) or other financial market participants. Accordingly, by 31 December 2013, the EBA, EIOPA and ESMA shall review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations.
2. The new Article 5b(1) covers not only the guidelines adopted by the three ESAs since their establishment in January 2011, but also all the guidelines and recommendations adopted by the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and Committee of European Securities Regulators (CESR), and which are still in force.
3. Article 76(4) of the founding regulations of the EBA, EIOPA and ESMA states that the Authorities shall be considered the legal successors of CEBS, CEIOPS and CESR respectively.

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4. Section II sets out the feedback statement to the Joint Consultation Paper JC-CP-2013-02 published by the three ESAs on 7 November 2013. Section III provides a definition for ‘sole or mechanistic reliance’. In Section IV, the concept of sole or mechanistic reliance is illustrated by general examples of rating references. While Section V lists provisions from the EBA, EIOPA and ESMA guidelines and recommendations containing rating references that should not be viewed as ‘sole or mechanistic’, Section VI lists a set of provisions that do require revision according to the ESAs. Annex I provides an impact assessment and Annex II lists the references to ratings contained in the Solvency II Directive.

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<sup>1</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.](#)

## II. Feedback Statement

5. The three ESAs received 22 responses to the Joint Consultation Paper (JCP) on ‘Mechanistic references to credit ratings in the ESAs’ guidelines and recommendations’ (JC-CP-2013/02). Out of the 22 responses, 21 responses provide answers to the first question of the JCP on the definition of ‘sole or mechanistic reliance’, 18 responses provide answers to the second question referring to the ‘proposed actions on the EBA and ESMA guidelines and recommendations, and 16 responses provide answers to the third and last question on ESMA’s proposed revision of the (CESR/ESMA) ‘Guidelines on a common definition of European money market funds’ (MMF Guidelines<sup>2</sup>).
6. Responses were received mainly from credit rating agencies, investors and associations representing the financial sector. The full text of those non-confidential responses received is available on the ESAs’ website<sup>3</sup>.
7. The answers provided by stakeholders allowed the three ESAs to gather information for the draft of this final report.
8. The new Article 5b(1) of the CRA Regulation – as amended by the CRA<sup>3</sup> Regulation – states that the EBA, EIOPA, and ESMA shall not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities, the entities referred to in the first subparagraph of Article 4(1) or other financial market participants.
9. The approach taken by the three ESAs to remove sole or mechanistic references to credit ratings is widely supported by all respondents. Nonetheless, some respondents, in particular the credit rating agencies, express their concern that the wording of the JCP in the Impact Assessment (Annex I) could incorrectly suggest that a prohibition or ban of credit ratings is envisaged.
10. EBA, EIOPA and ESMA would like to stress that the aim of this exercise is to remove regulatory references to sole or mechanistic reliance on credit ratings. Article 5b(1) unequivocally states that the EBA, EIOPA and ESMA shall review and remove, where appropriate, all such references to external credit ratings in existing guidelines and recommendations. A proposal to ban or prohibit the use of external credit ratings is not part of the ESAs’ mandate.

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<sup>2</sup> [http://www.esma.europa.eu/system/files/10\\_049.pdf](http://www.esma.europa.eu/system/files/10_049.pdf)

<sup>3</sup> [Joint Consultation on mechanistic references to credit ratings in the ESAs' guidelines and recommendations \(JC/CP/2013/02\)](#)

### Question 1: The definition of ‘sole or mechanistic reliance’

11. In their responses, nearly all the stakeholders agree with the proposed definition of sole or mechanistic reliance. The definition fits the overall objective of reducing over-reliance on credit ratings.
12. Few respondents raise concern about the exact wording of the definition. It is thought that the inclusion of the word ‘solely’ in the wording ’...any type of rule solely based on credit ratings’ may incorrectly exclude the concept of mechanistic reliance from the definition. The word ‘additional’ in the wording ‘...without any additional discretion’ may suggest that a degree of discretion exists in the first place, thus moderating the idea of ‘sole’ reliance.
13. The ESAs have taken note of the concerns expressed and decided to amend the definition as suggested.

### Question 2: Proposed action on the EBA and ESMA Guidelines and Recommendations

14. The approach proposed by the Joint Committee of the three ESAs is widely welcomed. Respondents positively note that the ESAs have identified several references that should not be considered to have sole or mechanistic reliance.
15. Broad agreement is received from respondents that the EBA’s (CEBS) ‘Revised Guidelines on the recognition of External Credit Assessment Institutions’ (EBA GL<sup>4</sup>) present a potential for mechanistic reference to ratings, but that it is inappropriate at this stage to repeal or amend these guidelines. It is recognised that Level2 guidelines cannot change Level1 legislation. Moreover, an amendment of the EBA GL before the entry into force of the ITS<sup>5</sup> that specify the mapping of ECAIs to the credit quality steps set out in the CRR could create a regulatory void.

### Question 3: RESMA’s MMF Guidelines

16. All 16 respondents who provided feedback to question 3 agree with the identification of mechanistic reliance in the guidelines. Most of the respondents agree on the principles-based approach taken by the ESAs in the proposed revision of the guidelines.
17. Nevertheless, a few respondents suggest improvements to the language to avoid misunderstandings. Six respondents believe that the proposed revision contradicts the objective of reducing reliance on external ratings. Those respondents consider it necessary to amend sentence 2 of paragraphs 47 and 48 of the JCP to ‘Such an assessment ~~should~~ may have regard to the credit rating(s) provided by one or

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<sup>4</sup> <http://www.eba.europa.eu/documents/10180/16094/Revised-Guidelines.pdf>

<sup>5</sup> Articles 136(1) and 270 of [Regulation \(EU\) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation \(EU\) No 648/2012 \('CRR'\)](#)

more credit rating agencies...' on the basis that the word "should" might inappropriately encourage the fund manager to use external ratings.

18. Some respondents also seek confirmation that fund managers do not have to consider the rating of each recognised CRA that has rated the instrument, but only the relevant CRA (i.e. the agency that provided the rating which the manager used for the initial assessment of credit quality). To avoid any misunderstanding on this point, two respondents propose that sentence 3 of paragraph 47 of the JCP should be read in the context of sentence 2 of paragraph 47.
19. The ESAs carefully considered the suggestion to amend sentence 2 of paragraphs 47 and 48. The ESAs note first of all that these suggestions should be seen against the background of the first sentence in paragraph 47, according to which managers should undertake their own assessment of credit quality. This is a key obligation which applies in every case. Therefore, while the ESAs are of the view that there should not be mechanistic reliance on external ratings, managers of money market funds (MMF) and short-term money market funds (STMMF) should take some note of this information. At the same time, the ESAs consider it important to point out that ratings are only one of the elements which managers should take note of regard (hence the introduction of 'inter alia' in the text).
20. With respect to the second comment, the ESAs wish to avoid a situation in which managers could choose to have regard only of certain external ratings that are more in line with their internal assessment of credit quality. Therefore, in the final guidelines, there is clarification that a downgrade of an instrument below the two highest short-term credit ratings in the case of a STMMF (or investment grade in the case of sovereign issuance for MMF) by any credit rating agency registered and supervised by ESMA should lead the manager to undertake a new assessment of the credit quality of the instrument.

### **III. Definitions**

21. CRA Regulation: Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies amended by Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 and by Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013.
22. CRA3 Regulation: 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.
23. National competent authorities: authorities as defined in Article 3(1)(p) of the CRA Regulation.
24. Sectoral competent authorities: authorities as defined in Article 3(1)(r) of the CRA Regulation.

### III.I. Definition of ‘sole or mechanistic reliance’

25. While the new Article 5b(1) of the CRA Regulation provides that the three ESAs should not refer to credit ratings where such references have the potential to trigger ‘sole or mechanistic reliance’ on credit ratings, the same Regulation does not include a formal definition of sole or mechanistic reliance nor explain its meaning in greater detail.
26. To have a clear and consistent understanding of ‘sole or mechanistic reliance’, the following definition is adopted:

*It is considered that there is sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion.*

27. This definition is based on the understanding reached by the European Parliament, the Council, and the Commission during the negotiations on the CRA3 Regulation. This understanding has not previously been translated into a formal definition.

### IV. General examples of provisions, texts and guidelines with references to credit ratings (non-exhaustive list)

28. This section contains examples which are intended to clarify the definition of ‘sole or mechanistic reliance’.

#### IV.I. EBA

29. The EBA has issued guidelines on the mapping of credit assessments to credit quality steps where the use of ECAs external ratings in the standardised approach (SA) of the capital framework could appear to constitute sole or mechanistic reliance. The use of external ratings to determine capital requirements, which will increase as a consequence of the rating changes that trigger a change in the credit quality steps, fall under the definition of mechanistic reliance, if there are no mitigating factors. As a result, the CRR has introduced some mitigating tools. Section V.I below sets out in more detail the use of external ratings and their mapping in the standardised approach and the provisions that mitigate the reliance on such ratings.

#### IV.II. EIOPA

30. EIOPA has not identified any guidelines, in force or currently under development, to be used as an example of mechanistic reliance. Instead of giving a hypothetical example, there follow illustrative provisions of the current draft implementing measures of the Solvency II framework.

### Use of ratings for solvency capital requirement calculation for spread risk

31. The design of the spread risk module requires objective market information on the credit quality of assets. This is the basis for the calibration of the standardised risk charge. When designing the module, other options were considered (e.g. using solvency ratios or internal ratings). However, the need to consider possible consequences in terms of increased market volatility should also be taken into account.
32. It was considered whether this example is indeed an example of sole or mechanistic reliance because paragraph 4 of Article 141 UECAI1 (in Annex III) states that if an item is part of the larger or more complex exposures of the insurance or reinsurance undertaking, the undertaking shall have its own internal credit assessment of the item and allocate it to one of the seven steps in a credit quality assessment scale ('reassessment').
33. The current design of spread risk calculation foresees a capital charge that depends on credit quality steps (CQS) as in the table below.

Credit quality step	0	1	2	3	4	5	6
Capital charge	0.9%	1.1%	1.4%	2.5%	4.5%	7.5%	7.5%

34. Since the CQS in the table above will be determined by using a mapping table (the table will be determined by EIOPA according to Article 138 RECAI2 of the draft implementing measures of SII) which will prescribe for each ECAI the mapping of its ratings to CQS, the procedure of calculating spread risk capital charge as foreseen in the draft implementing measures of SII might appear to constitute a mechanistic reliance on ratings. However, the existence of paragraph 4 of Article 141 mentioned above prevents such mechanistic reliance for items that make up part of larger or more complex exposures. The mapping will be determined by EIOPA based on the Joint Committee work on mapping led by the EBA to be finalised by end of 2013. EIOPA will be probably mandated with work on internal ratings.

### Cliff effects and the BBB limits

35. The provisions on the final design of the classical matching adjustment are still to be decided in the Omnibus II negotiations. However, as an example for the purpose of this paper the text of EIOPA's long-term guarantees (LTG) assessment was used, which includes a minimum credit quality (BBB and above), including a 33.3% limitation on the holdings of BBB investments. There is also a concern that

a downgrade of a small portion of a portfolio might lead to a complete loss of the matching adjustment. The current minimum credit quality restrictions introduce a cliff effect. Since matching portfolios are typically managed on a long-term basis, it is possible that assets that were originally of investment grade quality (BBB or above) may subsequently change to a lower grade.

#### IV.III. ESMA

36. According to the MMF Guidelines, short-term money market funds and money market funds should only invest in high quality money market instruments. A money market instrument should not be considered to be of high quality by managers of short-term money market funds and money market funds unless it has been awarded one of the two highest available short-term credit ratings by each recognised credit rating agency that has rated the instrument.

#### V. Guidelines and recommendations currently in force containing references to ratings which are NOT considered as sole or mechanistic

37. A number of guidelines and recommendations contain references to ratings, although in the cases mentioned below, these do not cause a mechanistic reliance, as set out in the definition in paragraph 13. Consequently these guidelines and recommendations will not be subject to amendments.

##### V.I. EBA: List of guidelines and recommendations with reference to external ratings

###### V.I.1 ‘CEBS Guidelines on Stress Testing (GL32)’, 26 August 2010

38. The EBA reviewed the previously issued guidelines and recommendations for references to external ratings. Listed below are the guidelines and recommendations that do not contain a mechanistic reliance on external ratings.

[www.eba.europa.eu/documents/10180/16094/ST\\_Guidelines.pdf](http://www.eba.europa.eu/documents/10180/16094/ST_Guidelines.pdf)

Page 34, Annex 3, paragraph 8.

*In computing the effect of stress tests on capital requirements, institutions may use methodologies coherent with the standardised framework. This requires developing a link between internal risk parameters and regulatory weights. If the institution uses external ratings it can infer, by the movements of the internal risk estimation, the rating migration.*

Page 42, Annex 5, paragraph 8.

*Three types of stress scenarios are expected to be applied: idiosyncratic, market-wide, and a combination of the two. The idiosyncratic stress might assume no rollover of unsecured wholesale funding and some outflows of retail deposits. In addition, a typical bank-specific scenario is, for example, a down-*

*grading (for example, a 3 notches downgrade) of an institution's debt instruments (including SPV issued CP) by external rating agencies. The market-wide stress might assume a decline in the liquidity value of some assets and deterioration in funding market conditions. In addition, market stress scenarios can involve market disruptions or changes in the macro-economic environment in which the institution is operating, or the downgrading of countries in which the institution is operating.*

#### **V.I.2 ‘High level principles for risk management’, 16 February 2010**

[www.eba.europa.eu/documents/10180/16094/HighLevelprinciplesonriskmanagement.pdf](http://www.eba.europa.eu/documents/10180/16094/HighLevelprinciplesonriskmanagement.pdf)

Page 3, paragraph 15.

*Institutions express their risk appetite and risk tolerance in a variety of forms, including setting a target credit rating or a target rate of return on equity (sometimes, but not always accompanied by a target limit on the variance of that return). It is important both that institutions set such targets, and that the targets be consistent with one another, as well as being consistent with the institution's obligation to maintain the risk to depositors within the constraints implied by capital and liquidity regulation. For example, supervisors can legitimately question how a bank can simultaneously achieve a high rate of return on equity and a narrow variance around that target rate of return. They may also question how a high target rate of return on equity can be consistent with maintaining a high credit rating throughout the business cycle.*

#### **V.I.3 ‘Guidelines on operational risk mitigation techniques’, 22 December 2009**

[www.eba.europa.eu/regulation-and-policy/operational-risk/guidelines-on-operational-risk-mitigation-techniques](http://www.eba.europa.eu/regulation-and-policy/operational-risk/guidelines-on-operational-risk-mitigation-techniques)

Page 3, paragraph 12.

*The Basel II regulatory framework allows banks to recognise the risk-mitigating impact of insurance if the insurer has a minimum claims paying ability rating of A (or equivalent). However, the CRD sets a less stringent standard. Paragraph 26 requires insurers to have a “minimum claims paying ability rating by an eligible ECAI which has been determined by the competent authority to be associated with a credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under Articles 78 to 83”. EU supervisors are governed by the CRD, and should therefore allow ratings equivalent to credit quality step 3 or better 3, based on the long-term claims paying ability rating of the insurer.*

Page 6, first bullet point.

*A haircut for counterparty default should be assessed on the basis of the credit quality of the insurance company responsible under the given contract, even if its parent institution has a better rating or the risk is transferred to a third party. Insurers with a lower claims paying ability should attract a higher haircut than insurers with a higher credit quality.*

**V.I.4 ‘Compendium of Supplementary Guidelines on implementation issues of operational risk’, 27 July 2010**

[www.eba.europa.eu/documents/10180/16094/Compendium\\_v2.pdf](http://www.eba.europa.eu/documents/10180/16094/Compendium_v2.pdf)

Page 26, Section 3.1, paragraph 12.

*The Basel II regulatory framework allows banks to recognise the risk-mitigating impact of insurance if the insurer has a minimum claims paying ability rating of A (or equivalent). However, the CRD sets a less stringent standard. Paragraph 26 requires insurers to have a ‘minimum claims paying ability rating by an eligible ECAI which has been determined by the competent authority to be associated with a credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under Articles 78 to 83’. EU supervisors are governed by the CRD, and should therefore allow ratings equivalent to credit quality step 3 or better 18, based on the long-term claims paying ability rating of the insurer.*

**V.I.5 ‘Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CPo3 revised)’, 25 January 2006**

[www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-the-application-of-the-supervisory-review-process-under-pillar-2](http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-the-application-of-the-supervisory-review-process-under-pillar-2)

Page 22, Section ICAAP 6, paragraph b.

*Institutions may take other considerations into account in deciding how much capital to hold, such as external rating goals, market reputation and strategic goals.*

Page 24, Section ICAAP 9, paragraph f.

*It is also important that institutions not rely on quantitative methods alone to assess their capital adequacy, but include an element of qualitative assessment and management judgement of inputs and outputs. Considerations such as external rating goals, market reputation and strategic goals should be taken into account in all three methodologies.*

**V.I.6 ‘Revised Guidelines on the recognition of External Credit Assessment Institutions’, 30 November 2010**

<http://www.eba.europa.eu/regulation-and-policy/external-credit-assessment-institutions-ecai/revised-guidelines-on-the-recognition-of-external-credit-assessment-institutions>

Pages 27-35, Part 3: 'Mapping' (see entire chapter).

**V.I.7 'Implementation guidelines on Article 106(2)(c) and (d) of Directive 2006/48/EC recast', 28 July 2010**

[www.eba.europa.eu/documents/10180/16094/GL\\_Article106\(2\).pdf](http://www.eba.europa.eu/documents/10180/16094/GL_Article106(2).pdf)

Page 7, III, Section 19.B.2.(c).iii.

*The credit institution with which the diversified exposures are placed shall have a credit assessment by an eligible External Credit Assessment Institution (ECAI) which has been determined by the competent authority to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions under Articles 78 to 83 of the CRD (i.e. under the standardised approach for the calculation of minimum capital requirements for credit risk).*

**V.II. EIOPA**

39. There are currently no guidelines adopted by EIOPA that contain references to ratings.
40. For information, Annex III provides a list of provisions in the Solvency II Directive that contain references to credit ratings.

**V.III. ESMA**

**V.III.1 EMIR**

41. Regulation No 648/2012 (EMIR)<sup>6</sup> does not contain any references to credit ratings. Implementing measures also did not include any references to credit ratings. Annexes I and II of Commission Delegated Regulation (EU) No 153/2013, when referring to the conditions that financial instruments should meet to be accepted as collateral or for central counterparties' (CCPs') investment purposes, explicitly avoid over-reliance on ratings as follows: 'the CCP can demonstrate to the competent authority that the financial instruments have been issued by an issuer that has low credit risk based upon adequate internal assessment by the CCP. In performing such an assessment, the CCP shall employ a defined and objective methodology that shall not fully rely on external opinions and that takes into consideration the risk arising from the establishment of the issuer in a particular country'.

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<sup>6</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

42. In the European legal and regulatory framework no reference is made to ratings in the margins, stress testing, back testing and sensitivity analysis requirements. However, it is not excluded that CCPs' internal rules and procedures might rely on ratings when developing their models.

### V.III.2 Prospectus

43. There are currently no guidelines adopted by ESMA that contain references to ratings.

## VI. Guidelines and recommendations currently in force containing references to ratings which are considered as sole or mechanistic and proposed action.

### VI.I. EBA: standardised approach and mapping

44. The standardised approach was proposed in the Basel II capital adequacy accord for banking institutions to enable them to calculate capital requirements for credit risk in a simple manner. The SA was subsequently introduced in the European Union via the CRD III legislation (Directives 2006/48/EC and 2006/49/EC<sup>7</sup>). The Basel III proposals are included in the recently approved CRD IV<sup>8</sup> legislation (Regulation EU No 575/2013 (CRR) and Directive 2013/36/EU (CRD)) and this retains the same approach, although it does request that the references to external ratings be revisited. To reduce any mechanistic reliance as far as possible, the CRD IV introduces a number of additional tools and requirements:
- a) Competent authorities are to encourage institutions that are significant in terms of their size, internal organisation and the nature, scale and complexity of their activities to develop internal credit risk assessment capacity and to increase use of the internal ratings-based approach for calculating capital requirements for credit risk. However, less sophisticated institutions will keep relying on external ratings. External ratings can also be used for less material exposure classes or in situations where using internal approaches would be burdensome.
  - b) Competent authorities are also required to monitor, taking into account the nature, scale and complexity of an institution's activities, that the institution does not solely or mechanistically rely on credit ratings for assessing the credit quality of financial instruments and counterparties.
  - c) From 2014 onwards and in cooperation with EIOPA and ESMA, the EBA should publish biannual reports about the extent to which legislation refers to external ratings, how to reduce such references and the degree of supervisory convergence.

<sup>7</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177/1, 30.6.2006)

<sup>8</sup> <http://eur-lex.europa.eu/JOHMT.html?uri=OJ:L:2013:176:SOM:EN:HTML>

45. Under the SA, banks are required to use ratings from External Credit Assessment Institutions (ECAIs) to quantify the required capital for credit risk. Articles 82 ff. of Directive 2006/48/EC introduce the concept of credit quality steps. These are explicitly related to ECAIs' ratings via the mapping that is specified in the EBA's 'Revised Guidelines on the recognition of External Credit Assessment Institutions'.<sup>9</sup> The mapping is available in a separate file on the EBA website.<sup>10</sup> An alternative mapping is provided for short-term credit assessment.
46. These EBA guidelines are intended to provide consistency across jurisdictions exclusively on the ECAI recognition for capital requirements related to the SA and the securitisation ratings-based approaches.
47. If neither the bank applying the SA nor the supervisor can intervene once the mapping has been set, this framework could be considered as a mechanistic reliance on external ratings. However, Article 3 of the CRR allows firms to apply measures stricter than those imposed by the Regulation, which could include applying risk weights higher than those required by the SA. Institutions may choose not to apply such higher risk weights, but they have the option of doing so under Article 3. Similarly, under Article 128 of the CRR, institutions have the option of assigning particularly high risk to any exposure under the standardised approach, which would result in the application of a risk weight that is unconnected to credit ratings.
48. The CRD III (and CRD IV) have six CQS and as the ECAIs' credit assessment scales are often much more granular than that, there needs to be a mapping between the ECAI scales and the CQS. This mapping links a range of ratings to a certain CQS and hence most external rating changes do not trigger a change in the CQS. Nonetheless, if an external rating change does trigger a change in the CQS, institutions applying the SA will have to use a different CQS to compute risk-weighted assets. This change may be considered mechanistic as institutions cannot rely on an alternative credit assessment.
49. The mapping process takes into account a number of qualitative and quantitative factors. The quantitative factors, if available, consider historical default rates in particular, whereas the qualitative factors include for instance differences in the definition of default, the methods of calculating historical default rates, the treatment of recently established ECAIs and the pools of issuers covered.
50. Under CRD III, securitisation exposures are addressed in a similar manner to the mapping described above for other credit exposures. The main difference is that the number of CQS for securitisation positions is less granular under the long-term SA as it only includes five CQS.

<sup>9</sup> [www.eba.europa.eu/documents/10180/16094/Revised-Guidelines.pdf](http://www.eba.europa.eu/documents/10180/16094/Revised-Guidelines.pdf)

<sup>10</sup> [www.eba.europa.eu/documents/10180/16151/4+August+2006\\_Mapping.pdf](http://www.eba.europa.eu/documents/10180/16151/4+August+2006_Mapping.pdf)

51. At the same time, the number of ECAIs actually providing ratings for securitisations is much smaller: there are only three ECAIs according to the mapping and six according to the data available in the current ESMA-CEREP database. Under CRD III, the mapping of CQS to external ratings for securitisation is addressed by the same ECAI guideline.
52. Apart from some technical details, however, the treatment is not different from that for exposures other than securitisations. Since there is a lack of sufficiently objective internal methodologies, most banks are expected to calculate their capital requirements by referring to external ratings.
53. Despite all the recommendations described above, the framework of the SA for credit risk can still be termed, at least to a certain extent, as mechanistic reliance. That issue, however, is not generated at the level of the guidelines but it is intrinsic in the Basel framework and in the European implementation thereof. Therefore, even if there is over-reliance, this cannot be corrected by any action of the ESAs, such as amending or repealing the guidelines, both for policy reasons (there is no available or agreed alternative), and for legal reasons (in the European Union, the guidelines/recommendations or delegated legislation and implementing measures cannot amend the CRR).
54. Furthermore, CRR introduces a mandate for the ESAs<sup>11</sup> to draft implementing technical standards (ITS) specifying the mapping of the ECAIs to credit quality steps. A similar mandate for a separate set of ITS requires EBA to produce a mapping for securitisation.<sup>12</sup> The ITS will automatically repeal the guidelines. Hence, amending or repealing the guidelines at this stage would have a very limited effect and without amendment of the basic legislation, would lead to a legal void until the entry into force of the final ITS.
55. The ITS (due to be delivered to the EU Commission by July 2014) contain an analysis of historical performance of external ratings and take into account additional qualitative considerations for the new mapping. These and the fact that the mapping is expected to be reviewed periodically will further decrease the reliance on external ratings.
56. For all the reasons listed above, the ESAs do not consider it appropriate to repeal or amend the guidelines to remove the references to external ratings. Further work is needed however, especially in the international context (most notably, the Basel Committee Task Force on the standardised approach) to find alternatives for the mapping to external ratings in the standardised approach and the mapping for

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<sup>11</sup> Article 136(1) of Regulation (EU) No 575/2013

<sup>12</sup> Article 270 of Regulation (EU) No 575/2013

securitisation exposures. EBA, ESMA and EIOPA will take into account the reliance on external ratings when developing the ITS on ECAIs mapping required by Regulation (EU) No 575/2013<sup>13</sup>.

## VI.II. EIOPA

57. There are currently no guidelines adopted by EIOPA that contain references to ratings.

## VI.III. ESMA: Revision of the MMF Guidelines

58. This section sets out a proposal for an amendment to the MMF Guidelines with respect to the assessment of the credit quality of money market instruments by managers of short-term money market funds and money market funds.
59. It is proposed to modify the guidelines by amending paragraph 4 of Box 2 and paragraph 2 of Box 3 as set out below.
60. Paragraph 4 of Box 2 would be replaced by the following:

*4. For the purposes of point 3a), ensure that the management company performs its own documented assessment of the credit quality of money market instruments that allows it to consider a money market instrument as high quality. Where one or more credit rating agencies registered and supervised by ESMA have provided a rating of the instrument, the management company's internal assessment should have regard to, inter alia, those credit ratings. While there should be no mechanistic reliance on such external ratings, a downgrade below the two highest short-term credit ratings by any agency registered and supervised by ESMA that has rated the instrument should lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of high quality.*
61. Paragraph 2 of Box 3 would be replaced by the following:

[...]

In addition, a Money Market Fund:

- 2. May, as an exception to the requirement of point 4 of Box 2, hold sovereign issuance of a lower internally-assigned credit quality based on the MMF manager's own documented assessment of credit quality. Where one or more credit rating agencies registered and supervised by ESMA have provided a rating of the instrument, the management company's internal assessment should have regard to, inter alia, those credit ratings. While there should not be mechanistic reliance on such external ratings, a downgrade below investment grade or any other equivalent rating grade by any agency registered and supervised by ESMA that has rated the instrument should lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of*

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<sup>13</sup> [http://ec.europa.eu/internal\\_market/bank/regcapital/legislation\\_in\\_force\\_en.htm](http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm)

*appropriate quality. ‘Sovereign issuance’ should be understood as money market instruments issued or guaranteed by a central, regional or local authority or central bank of a Member State, the European Central Bank, the European Union or the European Investment Bank.*

62. The merit of this approach is that it is more principles-based and avoids mechanistic reliance on credit ratings by removing the ‘floor’ set in the previous guidelines for eligibility of money market instruments for short-term money market funds (i.e. the reference to the top two credit ratings), while maintaining the obligation on the manager to take some note of external ratings. In the version proposed:

- the reference to credit ratings remains but there is no automatic exclusion of any rated money market instrument from the range of instruments of good credit quality based on a minimum rating provided by credit rating agencies;
- this means that managers should perform the assessment of the creditworthiness of money market instruments themselves and any downgrade of a money market instrument by a credit rating agency to below a certain threshold should be treated as material information by managers of MMFs, who should then undertake a new internal assessment of the instrument to ensure that the instrument is still of appropriate credit quality.

## Annex I: Impact Assessment on reducing sole or mechanistic reliance on credit ratings

### Introduction

This cost-benefit analysis provides the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

Among the observable effects of mechanistic reliance, the European Commission indicates that it would be desirable to reduce so-called ‘cliff effects’, which it defines<sup>14</sup> as ‘sudden actions that are triggered by a rating downgrade under a specific threshold, where downgrading a single security can have a disproportionate cascading effect’. Fire sales of assets may, for example, affect the downgraded issuer ‘because its access to the money market funding may suddenly close, which may affect its viability’.<sup>15</sup>

The acknowledgement of cliff effects builds on prior work from the Financial Stability Board and the IMF, with the latter highlighting<sup>16</sup> the ‘second-round liquidity effect’ that a rating change may trigger, whereby the credit quality of a rated entity can be affected by the higher cost of capital resulting from a rating change. The higher cost of capital following downgrades is also referred to in the academic literature<sup>17</sup>, as ‘a rating downgrade may lead to higher cost of capital for the borrowing firm because it induces a deterioration in investors’ perceptions about the credit quality of the borrowing firm, because of regulations that restrict investors’ holdings of lower rated bonds, or because of rating triggers in financial contracts’.

In October 2010, the FSB endorsed principles to reduce public authorities’ and financial institutions’ reliance on credit rating agency ratings.<sup>18</sup> The goal of these principles is to end mechanistic reliance on ratings by banks, institutional investors and other market participants. To accelerate implementation, the FSB published a roadmap with timelines in November 2012. The roadmap suggests a two-pronged approach: (1) reducing mechanistic reliance in standards, laws and regulations; and (2) encouraging financial institutions to strengthen and disclose their credit risk assessment processes. The FSB is also undertaking a thematic peer review, whose main objective is to help national authorities fulfil their commitments under the roadmap.

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<sup>14</sup> European Commission Impact Assessment accompanying the document the “Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies” and a “Proposal for a Directive amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers” ([http://ec.europa.eu/internal\\_market/securities/docs/agencies/SEC\\_2011\\_1354\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/agencies/SEC_2011_1354_en.pdf))

<sup>15</sup> European Commission Impact Assessment accompanying the document “Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds” ([http://ec.europa.eu/internal\\_market/investment/docs/money-market-funds/130904\\_mmfs-impact-assessment\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-impact-assessment_en.pdf))

<sup>16</sup> IMF Global Financial Stability Report, October 2010, Chapter 3: “The uses and abuses of sovereign credit ratings” (<http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/chap3.pdf>)

<sup>17</sup> G. Manso, UC Berkeley, “Feedback effects of credit ratings” (<http://faculty.haas.berkeley.edu/manso/ratings.pdf>)

<sup>18</sup> [http://www.financialstabilityboard.org/publications/r\\_101027.pdf](http://www.financialstabilityboard.org/publications/r_101027.pdf)

This preliminary impact assessment can be summarised in three main points. First, there could be potentially significant cliff effects from the EU money market funds industry, which has about EUR 1tn in assets under management, due to mechanistic reliance on external ratings in the current investment guidelines that could result in sudden and substantial changes in the universe of investable assets. Second, the vast majority of banking institutions across EU Member States currently use the SA to calculate their capital requirements for credit risk. Nonetheless, it is thought that a very small part of the exposures is associated to external ratings. In the insurance sector, the use of credit quality steps as part of the solvency capital requirement for the calculation of the spread risk capital charge could eventually lead to additional mechanistic reliance on external ratings and therefore potentially to cliff effects.

These examples illustrate the importance of reducing mechanistic reliance on external ratings in certain areas as it may have the potential to disrupt financial markets, reduce the benefits brought about by various regulatory initiatives and threaten the ESAs' financial stability objective.

## 1. CESR/ESMA MMF Guidelines

### a. EU MMF industry

In these guidelines, money market funds are split between short-term money market funds (STMMFs) and money market funds (MMFs). For the purpose of this impact assessment, the following two points are relevant in that distinction:

- STMMFs are required to invest in securities with a residual maturity of less than or equal to 397 days and have a portfolio-weighted average maturity that does not exceed 60 days, while MMFs do not face the same security maturity restriction as long as their portfolio-weighted average maturity does not exceed 6 months<sup>19</sup>;
- STMMFs are required to invest in securities that have been awarded 'one of the two highest available short-term credit ratings by each recognised credit rating agency, or non-rated securities with credit quality equivalent to one of these two ratings, while MMFs may also invest in sovereign debt instruments rated at least investment grade<sup>20</sup>.

Although growth of the EU MMF industry has slowed in recent years, it remains significant nonetheless. In the peer review of MMF Guidelines<sup>21</sup> conducted last year, ESMA gathered information from NCAs on the number of MMFs in the EU and MMF assets under management (Table T.01). According to this data,

<sup>19</sup> Box 2 points 5 and 7, and Box 3 point 5 of the MMF guidelines.

<sup>20</sup> Box 2 point 4 and Box 3 points 1 and 2 of the MMF guidelines.

<sup>21</sup> ESMA Peer Review – Money Market Fund Guidelines ([http://www.esma.europa.eu/system/files/2013-476\\_-\\_peer\\_review\\_-\\_money\\_market\\_fund\\_guidelines.pdf](http://www.esma.europa.eu/system/files/2013-476_-_peer_review_-_money_market_fund_guidelines.pdf))

EU MMF assets amounted to EUR 1,039bn in 2012, including EUR 779.9bn for STMMFs only, and the number of funds totalled 1,242.

STMMF and MMF overview						T.01
	Number of funds			Assets under management (EUR mn)		
	STMMF	MMF	Total	STMMF	MMF	Total
AT		7	7		405	405
BE	2	7	9	165	507	672
BG	0	7	7			
CZ		3	3		104	104
DE		24	24		4 089	4 089
DK		2	2		191	191
EL	5	17	22	52	673	725
ES	4	67	71	207	8 757	8 964
FI	3	10	13	843	2 925	3 768
FR	295	346	641	221 936	175 388	397 324
HU	32	25	57			
IE	97	5	102	303 510	1 966	305 476
IT	0	12	12		8	8
LT		1	1		12	12
LU	95	108	203	247 167	52 183	299 350
LV	0	2	2			
MT	4	2	6	33	197	230
NL		1	1		150	150
PL		2	2		196	196
PT		9	9		275	275
RO		1	1		3 690	3 690
SE	13	11	24	2,236	6 255	8 491
SI		3	3		23	23
SK		2	2		172	172
UK	10	8	18	3,779	1,035	4,814
<b>Total EU</b>	<b>560</b>	<b>682</b>	<b>1 242</b>	<b>779 928</b>	<b>259 201</b>	<b>1 039 130</b>

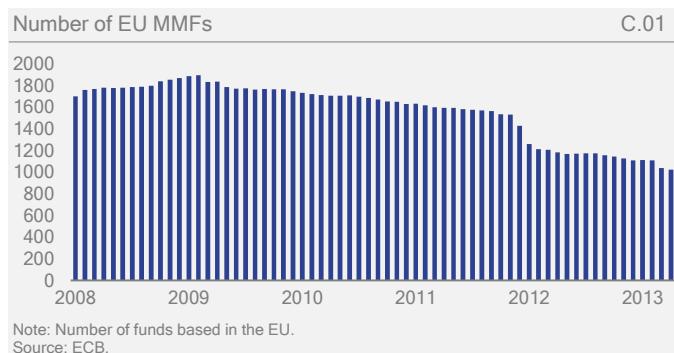
Note: Data and ECB exchange rates (for funds based outside the EA) as of 21 September 2012, which was the questionnaire deadline. Countries with no data were left out (EE, LI). STMMFs and MMFs listed based on self-declaration by funds.

Sources: National competent authorities, ECB, ESMA.

MMFs are highly concentrated geographically with more than 50% based in FR (641) and another 25% based in LU (203) and IE (102). Assets under management reflect this concentration with 38.2% of the total in FR, 29.4% in IE and 28.8% in LU.

ECB data provides a broadly similar picture with 1 157 EU MMFs as of September 2012 and EA MMF assets adding up to EUR 961.2bn (compared with EUR 1 021.6bn using the ESMA dataset). The ECB data shows slightly less concentration with 430 MMFs in FR (37% of the total), 294 in LU (25%) and 100 in IE (9%).

ECB data shows that the number of EU MMFs has declined by nearly 50% from a high of 1 896 in February 2009 to 1 012 as of May 2013. According to the ESRB, part of this decline ‘occurred in the form of a consolidation of the sector following the implementation of the CESR/ESMA guidelines [MMF Guidelines]<sup>22</sup>.’



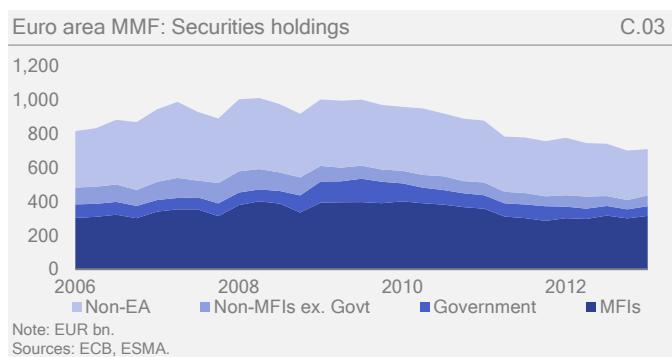
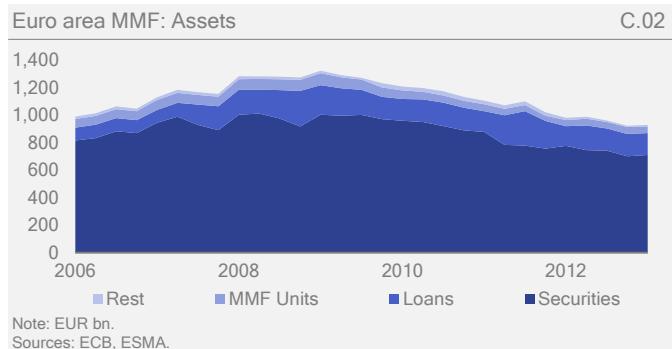
#### b. Euro area MMF assets

The ECB dataset also includes useful details on the assets of MMFs based in euro area (EA) countries, which amounted to 98.3% of total EU MMF assets (based on the data gathered by ESMA in its peer review of MMF Guidelines). EA MMF assets comprise a significant amount of debt securities (EUR 741.6bn as of Q3 2012, or 77.2% of total assets), followed by loans (EUR 161.6bn, 16.8% of assets) and shares of other MMFs (EUR 47.5bn, 4.9% of assets). The shares of these assets in MMF balance sheets have remained broadly constant over time, as illustrated in C.02.

The securities held by EA MMFs were largely issued by other EA MFIs (EUR 317bn, 42.7% of all securities held by MMFs), and to a lesser extent by EA governments (EUR 56.7bn, 7.6% of the total) and non-MFIs excluding governments (EUR 58.4bn, 7.9% of the total). The share of EA government securities has decreased over time, from 14% in Q1 2009 to 8% in Q3 2012 (Chart C.03). Holdings of securities issued by non-EA entities—for which the data is not as granular—amounted to a total of EUR 309.4bn.

<sup>22</sup> Annex to the ESRB Recommendation on money market funds

([http://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB\\_2012\\_1\\_annex.en.pdf?693f2e8ca5f8e87fa7ad424aca81fa52](http://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_1_annex.en.pdf?693f2e8ca5f8e87fa7ad424aca81fa52))



These numbers are broadly comparable with data from the ESRB survey, which show that both STMMF and MMF portfolios are heavily weighted towards MFI assets, with a much smaller proportion of non-financial corporations and government assets (T.02).

EU MMF securities portfolio					T.02
	MFIs	Non-financial corporations	Government	Other financial intermediaries	
ESRB Survey	75.2	9.6	13.1	2.1	
ECB Data	75.5	6.6	11.1	6.9	

Note: EU MMF holdings of securities by type of issuer, in % of total.  
Sources: ESRB, ECB.

### c. Investable universe and cliff effects

As required in the MMF Guidelines, to ensure portfolio are high quality, EU MMFs can only invest in specific assets (see box). As a case study, this impact assessment focuses on the investable universe of EU

MMF in relation to EU sovereign debt securities. The case of sovereign downgrades is of particular interest as these have significant spill-over effects, as highlighted in the economic literature<sup>23</sup>.

### Quantifying the investable universe

The investable universe of EU MMF is defined in the MMF Guidelines. The guidelines disclose the rating requirements for STMMFs in Box 2, ‘a money market instrument [is considered] not to be of high quality unless it has been awarded one of the two highest available short-term credit ratings by each recognised credit rating agency that has rated the instrument’. Regarding MMFs other than STMMF, Box 3 adds that these may ‘hold sovereign issuance of at least investment grade quality’. Despite the non-binding dimension of these guidelines, ESMA saw that 19 out of 27 NCAs have followed the CESR recommendations by establishing a distinction between STMMF and MMF, with 18 countries complying with the sovereign debt requirement. All the major MMF host countries have complied with the Guidelines.

In order to estimate the MMF investable universe, the first step was to collect the short-term ratings of each Member State as of the end of 2012 from the three major CRAs (T.03). Although there are more than three CRAs in the EU, credit ratings tend to be aligned<sup>24</sup> and these three CRAs account for a significant share of the overall market. EU Member States were then split between three categories:

- those with one of the two highest available short-term credit ratings;
- those with an investment grade but not eligible for EU STMMF investment;
- those with a non-investment grade.

We then calculated the amount of sovereign debt for each category in order to estimate the eligible investable universe. The EU sovereign debt data include short-term (with maturity equal to or less than a year) and long-term securities from Eurostat’s government finance statistics, with an aggregate value of EUR 8.8tn. Although not all government debt securities are marketable, the lack of consistency between estimates of marketable debt across the EU led us to simply use gross debt data from Eurostat without retreatment.

<sup>23</sup> Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, *Sovereign Rating News and Financial Markets Spill-overs: Evidence from the European Debt Crisis*, March 2011, WP/11/68.

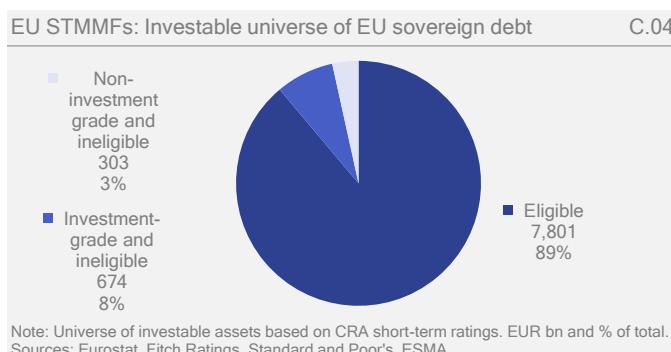
<sup>24</sup> Annalisa Croce, Stefano Lugo and Robert Faff (2011), *Rating alignment, Rating shopping and Reputation of credit rating agencies: evidence from the subprime crisis*.

Short-term rating eligibility for EU STMMF			T.03
	Fitch Ratings	Moody's	S&P
Eligible under MMF Guidelines*	F1+ F1 F2	P-1 A-1 P-2	A-1+ A-1 A-2
Ineligible	F3 B, C RD, D	P-3 Not Prime	A-3 B, C SD, D

Note: S&P's and Fitch's top ratings are split between A-1+ and A-1 and F1+ and F1, respectively. Therefore the three highest ratings from S&P and Fitch are eligible for EU STMMF investment. Since F3, P-3 and A-3 are investment grades, these ratings are eligible for MMFs but not eligible for STMMFs. Non-investment grades start at B and Not Prime. Source: Fitch Ratings, Moody's, Standard & Poor's, ESMA.

\*Disclaimer: T.03, initially published on 6 February 2014, has been replaced by an updated table on 11 February 2014, to reflect that Fitch Ratings, like S&P top rating, is split between F1+ and F1, and not as initially stated as only having F1 and F2.

The EU sovereign debt instruments eligible for EU STMMF investment under the MMF guidelines amounted to EUR 7.8tn as at the end of 2012, equivalent to 88.9% (96.5% of the total) of all EU government debt securities (C.04). This number is larger (EUR 8.5tn) for MMFs other than STMMFs, as the investment guidelines for the latter category are stricter. The gradual deterioration in creditworthiness of some EU sovereigns led to a shrinkage in the investable universe, which in turn may have led to a concentration of MMF investments in eligible EU sovereign debt that could potentially magnify future cliff effects.



The case of Spanish (ES) government bonds in October 2012 provides an example of a sudden shrinkage in STMMF investable universe and potential cliff effect. ES government bonds account for 7.6% of all EU sovereign debt securities (EUR 669bn) and a significant portion were eligible for STMMF investment until

the October 2012. On 12 October 2012, Spain's short-term debt rating was downgraded by S&P's from A-2 to A-3, making all ES sovereign debt securities overnight ineligible for EU STMMF investments.<sup>25</sup>

There are currently eight Member States with a short-term rating of A-2 from S&P and a rating of F2 or higher from Fitch Ratings (T.04). In each case, a downgrade by S&P would result in ineligibility of the sovereign debt stock for STMMF investment. Such a rating change for any individual Member State would shrink the investable universe of STMMFs further by between EUR 3.9bn and 1.655bn (the latter figure amounts to 18.9% of total EU sovereign debt securities). In an extreme case, a hypothetical downgrade of all A-2 rated Member States would lead to an equivalent reduction of the investable universe by around 1.9tn.<sup>26</sup>

EU sovereign debt securities and short-term ratings		T.04	
	Amount	S&P	Fitch
AT	185,116	A-1+	F1+
BE	330,132	A-1+	F1+
BG	4,929	A-2	F3
CY	9,186	C	B
CZ	62,651	A-1+	F1
DK	91,837	A-1+	F1
EE	246	A-1+	F1
ES	669,027	A-3	F2
FI	83,020	A-1+	F1
FR	1,546,058	A-1+	F1
DE	1,547,158	A-1+	F1
GR	93,614	SD	B
HU	59,118	B	B
IE	89,289	A-1+	F1+
IT	1,655,283	A-2	F2
LV	3,866	A-2	F2
LT	10,671	A-2	F2
LU	5,000	A-1+	F1+
MT	4,477	A-2	F1
NL	331,257	A-1+	F1+
PL	181,244	A-2	F2

<sup>25</sup> In addition, given the alignment of many non-sovereign debt ratings to the sovereign and that several banks are in the process of being recapitalised, the overall reduction in investable universe may be even larger than the impact in the sole area of sovereign debt securities.

<sup>26</sup> In addition, mechanistic reliance may have the undesirable consequence of STMMFs anticipating potential future downgrades and assets ineligibility, with some MMFs reducing early their holdings of government and/or private sector debt, thereby affecting the liquidity position of the sovereign and/or private entities and adding to the pressure on their creditworthiness.

PT	110,661	B	B
RO	30,899	B	F3
SK	32,799	A-1	F1
SI	16,252	A-2	F2
SE	119,194	A-1+	F1+
UK	<b>1,505,769</b>	A-1+	<b>F1</b>

Note: Data as of end 2012 in EUR million. Moody's short-term ratings were not used due to their limited availability.

Sources: Eurostat, Fitch Ratings, Standard & Poor's.

## 2. The standardised approach under CRD IV legislation<sup>27</sup>

Under the IV, credit institutions can choose between two approaches for the calculation of capital requirements for credit risk, namely the standardised approach (SA) and the internal ratings-based approach (IRBA).

The SA is widely used among European banks. While many institutions rely fully on the SA, banks using the IRBA also tend to have significant exposures under the SA, subject to the partial use requirements in the CRR. A recent study by the EBA found that out of a sample of 89 IRBA banks on average 30% of risk weighted assets stemmed from the SA.<sup>28</sup>

The impact of prohibiting the use of external ratings could be substantial, given the wide usage of the SA. However, in many cases the capital requirements under the SA do not depend on the use of external ratings, as explained in detail below. Furthermore, given that this Report does not propose any changes at this point in time, there will be no immediate impact of this proposal.

When assessing the impact of reducing the reliance on external ratings by prohibiting their use under the SA, for many types of exposures under the SA banks will not be allowed to use an external rating when determining capital requirements. This relates to the following exposure classes under the SA: exposures to certain international organisations; retail exposures; exposures secured by mortgages on immovable properties; exposures in default; exposures associated with particularly high risk; equity exposures; and some other items. Those exposure classes where external ratings may be used are exposures to central governments or central banks; exposures to regional governments or local authorities; exposures to public sector entities; exposures to multilateral development banks; exposures to institutions; exposures, exposures to corporates; exposures in the form of covered bonds; items representing securitisation positions; and exposures in the form of shares in collective investment undertakings.

<sup>27</sup> Regulation EU No. 575/2013 (CRR) and Directive 2013/36/EU

<sup>28</sup> [Review on the consistency of Risk Weighted Assets, First interim Report on the review of the consistency of risk-weighted assets](#).

In many cases external ratings are not available for exposures falling within the abovementioned exposure classes and/or the current provisions of the CRR already provide incentives not to use external ratings:

Exposures to Member States' central governments and central banks denominated and funded in domestic currency will receive a 0% risk weight, regardless of an external rating of the Member State. Until the end of 2017 (transitional rule set out in Article 495(2) of the CRR) the same risk weight will apply if exposures are denominated and funded in the domestic currency of any other Member State. After that date, those exposures will be risk weighted according to external ratings (if available). With these rules, a large portion of banks' exposures to sovereigns and central banks will already be covered without the reliance on external ratings. In addition, banks may use the credit assessments by export credit agencies to determine the capital requirements for exposures to central governments or central banks. Only in all remaining cases may the capital requirements maybe linked to external ratings, the most notable example being exposures in the form of US government bonds.

Exposures to regional governments, local authorities and public sector entities can, under certain conditions, be treated as exposures to the central government with the exemptions applicable as explained above. Only in cases where this preferential treatment is not applicable may banks use external ratings.

For exposures to multilateral development banks (MDBs), the CRR allows the application of a 0% risk weight for a specific list of MDBs. Banks may use external ratings only for exposures to MDBs not included in this list.

The materiality of the use of external ratings will also likely be low for exposures to corporates. Typically, only very large corporates will have an external rating. In many jurisdictions, smaller and medium-sized companies will be unrated and the 100% risk weight will apply. Furthermore, rated corporates will usually be assigned to CQS 2 and below where the effect of using an external rating will in most cases be not material (for CQS 3 and 4 the risk weight is 100%). Therefore, the incentive for banks to use external ratings for the corporate exposure class may only be very limited. Large corporates, which typically are externally rated, tend to be customers of larger institutions, who are more likely to use IRB models. Therefore also limited use of ratings appears likely, although this is a statement that can only be made with some caution.

The use of external ratings will be much more material for exposures to institutions and exposures in the form of covered bonds. Banks have a strong incentive to rely on external ratings for both these exposure classes. For exposures to institutions with an external rating qualifying for CQS 1 to 3 the corresponding risk weight will be below 100%. If the institution is unrated but there is an external rating available for the central government of the jurisdiction in which the institution is incorporated, the risk weight will also be below 100% if the external rating of the central government is assigned to CQS 1 or 2. A similar treatment applies to exposures in the form of covered bonds.

The use of external ratings of exposures representing securitisation positions is also very material. Institutions have a strong incentive to use external ratings because unrated securitisation positions will receive a 1.250% risk weight, subject to some limited exemptions.

## Annex II: References to credit ratings in the Solvency II Directive (Directive 2009/138/EC)

### Article 141 UECAI<sup>2</sup>

#### (Article 109a of Directive 2009/138/EC)

##### General requirements

- (1) An insurance or reinsurance undertaking shall nominate one or more ECAI to be used for the determination of the different parameters to derive the capital requirements of the various modules of the Solvency Capital Requirement standard formula and, where relevant, to derive the matching premium.
- (2) The use of ECAI credit assessments shall be consistent and such assessments shall not be used selectively.
- (3) When using credit assessments, insurance and reinsurance undertakings shall comply with the following requirements:
- (a) an insurance or reinsurance undertaking which decides to use the credit assessments produced by a nominated ECAI for a certain class of items shall use those credit assessments consistently for all items belonging to that class;
  - (b) an insurance or reinsurance undertaking which decides to use the credit assessments produced by a nominated ECAI shall use them in a continuous and consistent way over time;
  - (c) an insurance or reinsurance undertaking shall only use nominated ECAI credit assessments that take into account all amounts of principal and interest owed;
  - (d) where only one credit assessment is available from a nominated ECAI for a rated item, that credit assessment shall be used to determine the capital requirements for that item;
  - (e) where two credit assessments are available from nominated ECAIs and the two correspond to different parameters for a rated item, the assessment generating the higher capital requirement shall be used;
  - (f) where more than two credit assessments are available from nominated ECAIs for a rated item, the two assessments generating the two lowest capital requirements shall be referred to. If the two lowest capital requirements are different, the assessment generating the higher capital requirement of those two credit assessments shall be used. If the two lowest capital requirements are the same, the assessment generating that capital requirement shall be used;
  - (g) where available, insurance and reinsurance undertakings shall use both solicited and unsolicited credit assessments.
- (4) If an item is part of the larger or more complex exposures of the insurance or reinsurance undertaking, the undertaking shall have its own internal credit assessment of the item and allocate it to one of the seven steps in a credit quality assessment scale ('reassessment'). If the own internal credit assessment generates a lower capital requirements than the one generated by the credit assessments available from nominated ECAIs, then this own internal credit assessment shall not be considered for the purpose of this Regulation.

(5) For the purpose of paragraph 4, the larger or more complex exposures of an undertaking shall include tradable securities or other financial instruments based on repackaged loans and those defined in the implementing technical standards adopted in accordance with Article 111(c) of Directive 2009/138/EC.

Article 142 UECAI3

(Article 109a of Directive 2009/138/EC)

Issuers and issue credit assessment

(1) Where a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure belongs, then this credit assessment shall be used to determine the capital requirement and, where relevant, to derive the matching premium to be assigned to that item.

(2) Where no directly applicable credit assessment exists for a certain item, but a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure does not belong or a general credit assessment exists for the issuer, then that credit assessment shall be used in either of the following cases:

(a) it produces the same or higher capital requirement than would otherwise be the case and the exposure in question ranks pari passu or junior in all respects to the specific issuing program or facility or to senior unsecured exposures of that issuer, as relevant;

(b) it produces the same or lower matching premium than would otherwise be the case and the exposure in question ranks pari passu or junior in all respects to the specific issuing program or facility or to senior unsecured exposures of that issuer, as relevant.

(3) In cases which do not meet either points (a) or (b) of paragraph 2, it shall be considered that there is no credit assessment by a nominated ECAI available for the exposure.

(4) Paragraphs 1 and 2 shall not prevent the application of Articles 163(1) and 170(1).

(5) Credit assessments for issuers within a corporate group shall not be used as the credit assessment for another issuer within the same corporate group.

Article 142bis UECAI3bis

(Article 109a of Directive 2009/138/EC)

Double credit rating of tradable securities or other financial instruments based on repackaged loans Notwithstanding Article 141 UECAI2 (3)(d), where only one credit assessment is available from a nominated ECAI for a tradable security or other financial instrument based on repackaged loans, that credit assessment shall not be used and the capital requirements for that item shall be calculated and, where relevant, the matching premium shall be derived as if no credit assessment by a nominated ECAI is available.