



JOINT COMMITTEE OF THE EUROPEAN  
SUPERVISORY AUTHORITIES

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**Final Report**

**Good Supervisory Practices for Reducing Mechanistic Reliance on  
Credit Ratings**

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## Who should read this report?

This report should be read by **Sectoral Competent Authorities (SCAs)** in charge of supervising credit institutions, investment firms, insurance and reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties.

The purpose of this report is to assist these SCAs in their responsibilities of:

- monitoring the adequacy of their supervised entities credit risk assessment processes;
- assessing the use of contractual references to credit ratings; and where appropriate,
- encouraging them to mitigate the impact of any such references.

The purpose being to reduce sole and mechanistic reliance on credit ratings, in line with specific sectoral legislation.

## Table of contents

<b>I.</b>	<b>Executive Summary and Reasons for Publication</b>	<b>5</b>
<b>II.</b>	<b>Background</b>	<b>7</b>
<b>III.</b>	<b>Structure and Approach</b>	<b>8</b>
<b>IV.</b>	<b>General Good Practices</b>	<b>9</b>
IV.I.	<i>Rationale for Good Practice on Operational Procedures and Governance</i>	9
	General Good Practice 1: On operational procedures and governance	9
IV.II.	<i>Rationale for Good Practice on alternative and complementary measures to credit ratings</i>	9
a.	General considerations on internal credit risk assessments	9
b.	Examples of Market Based Alternatives	11
(i)	Bond Pricing Information	11
(ii)	Credit Default Swap Pricing Information	12
	General Good Practice 2: On the methodologies to substitute or complement credit ratings	13
IV.III.	<i>Rationale for Good Practice on proportionality</i>	13
	General Good Practice 3: On Proportionality	13
<b>V.</b>	<b>Specific Good Practices</b>	<b>15</b>
V.I.	<i>Investment Decisions</i>	15
	Specific Good Practice 1: Investment Decisions	16
V.II.	<i>Investment Advice</i>	16
	Specific Good Practice 2: Investment Advice	17
V.III.	<i>Investment Mandates</i>	17
	Specific Good Practice 3: Investment Mandates	18
V.IV.	<i>Collateral management and haircuts</i>	18
	Specific Good Practice 4: Collateral management and haircuts	20
V.V.	<i>Reference to and use of Benchmarks</i>	20
	Specific Good Practice 5: Reference to and Use of Benchmarks	20
V.VI.	<i>Communication</i>	21
	Specific Good Practice 6: Communication	21
<b>VI.</b>	<b>Conclusions</b>	<b>22</b>



JOINT COMMITTEE OF THE EUROPEAN  
SUPERVISORY AUTHORITIES

## Acronyms

AIFM	Alternative Investment Fund Manager
CDS	Credit Default Swap
CRA	Credit Rating Agency
CRA Regulation	Credit Rating Agencies Regulation - Regulation (EC) No 1060/2009
CRA 3 Legislative Package	The CRA 3 Legislative Package includes i) Regulation (EU) No 462/2013 and ii) Directive 2013/14/EU
CRD IV	Capital Requirements Directive - Directive 2013/36/EU
ESMA	European Securities and Markets Authority
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority
ESAs' Regulations	The ESAs' Regulations include i) Regulation (EU) 1095/2010 (ESMA Regulation), ii) Regulation (EU) No 1093/2010 (EBA Regulation), and iii) Regulation (EU) No 1094/2010 (EIOPA Regulation)
IORP	Institutions for Occupational Retirement Provision
JC	Joint Committee
OTC	Over the Counter
SCA	Sectoral Competent Authority



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## I. Executive Summary and Reasons for Publication

1. As set out in Article 5a(2) of the CRA Regulation, SCAs responsible for the supervised entities referred to in Article 4(1) of the CRA Regulation<sup>1</sup> are required to monitor the adequacy of the entities' credit risk assessments, assessing the use of **contractual references** to credit ratings<sup>2</sup> and, where appropriate, encouraging them to mitigate the impact of such references with a view to reducing sole or mechanistic reliance on credit ratings. This should be done in line with specific sectoral legislation.
2. This requirement is supported by other elements of the CRA 3 legislative package which amended the IORP, UCITS and AIFM Directives<sup>3</sup> and introduced similar requirements for SCAs to monitor the reference to ratings in the investment policies of the entities subject to these pieces of legislation. EU Member States were required to adopt this internal legislation within 18 months after the entry into force of CRA 3 package.
3. In order to assist SCAs in these tasks and ensure the necessary degree of cross-sectoral consistency, the Joint Committee of the ESAs created a task force to develop guidance that would coordinate the implementation of these new tasks under the CRA 3 legislative package.
4. This report represents the outcome of the task force's work, it is provided in accordance with Article 56 of the ESAs' Regulations which sets out that the ESAs may reach joint positions where appropriate and Article 29 of the ESAs' Regulations which provides for the authorities to play an active role in building a common supervisory culture and consistent supervisory practices.
5. The report is structured in a way to provide SCAs with an overview of how they may approach their supervisory responsibilities under the CRA 3 legislative package from both a general and specific perspective. This is achieved through proposing a set of **non-binding** general and specific good supervisory practices concerning the use of CRA<sup>4</sup> credit ratings. In this context, unless stated otherwise, throughout the paper the term 'credit rating' refers to credit ratings issued by credit rating agencies.

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<sup>1</sup> Credit Institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties.

<sup>2</sup> According to Article 3(1)(a) of the CRA Regulation 'credit rating' means an opinion regarding the creditworthiness of an entity debt or financial obligation, debt security, preferred share, or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share, or other financial instrument, issued using an established and defined ranking system of rating categories

<sup>3</sup> Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013

<sup>4</sup> Article 3(1)(b) of the CRA Regulation specifies that 'credit rating agency' means a legal person whose occupation includes the issuing of credit ratings on a professional basis.

6. The purpose of the general practices is to propose a common framework for the treatment of references to credit ratings in credit assessments, suggest potential alternative or complementary measures to credit ratings and outline how to address issues of proportionality arising from the differing nature scale and complexity of supervised entities. The purpose of the specific practices is to establish a common approach with regards to the supervision of how credit ratings are used across specific business processes, where credit ratings are most in danger of being used in a mechanistic way.
7. In reading both sets of practices included in this report it is relevant to refer to the Joint Committee Final Report on Mechanistic References to Credit Ratings (JC 2014-004)<sup>5</sup>, which defined Sole and Mechanistic reliance on credit ratings as follows:

*“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”.*
8. In addition, it is worth highlighting that as per the terms of Article 5(a), the goal of this report is to help SCAs to assess and address the use of and the reliance on **contractual references** to credit ratings by their supervised entities. This should be considered distinct from any existing regulatory provisions which refer to the use of credit ratings.
9. It must be emphasised that the purpose of employing an internal credit risk assessment or market based alternatives, as suggested throughout this document, is not to replace credit ratings outright for the purposes of a credit risk assessment, but rather to provide an additional independent reference point on which the entity can base its credit assessment. This principle should be considered for every good practice recommended by this document. In addition it is not intention of this report to consider internal credit risk assessments superior or of higher quality than credit ratings, as both of these have pros and cons depending on the particular business application, and each can entail particular intrinsic risks. In contrast, the purpose of this document is to outline good practices to prevent the sole or mechanistic use of credit ratings by complementing those assessments with alternative measures of creditworthiness.
10. For the avoidance of doubt, under the terms of Article 3(1)(r) of the CRA Regulation, SCAs means the national competent authorities designated under the relevant sectoral legislation for the supervision of:
  - Credit institutions.
  - Investment firms.

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<sup>5</sup> <http://www.eba.europa.eu/documents/10180/534414/JC+2014+004+%28Final+Report+Mechanistic+References+to+Credit+Ratings%29.pdf>

- Insurance undertakings.
  - Reinsurance undertakings.
  - Institutions for occupational retirement provision.
  - Management companies.
  - Investment companies.
  - Alternative investment fund managers.
  - Central counterparties.
11. In this regard it is noted that, for credit institutions and investment firms, CRD IV includes regulatory requirements for SCAs (e.g. in Article 77(2) and Article 79(b)) to ensure that those institutions do not solely or mechanistically rely on credit ratings in their credit risk assessments processes for calculating own funds requirements. As such it is recognised that different sectoral legislative measures may have been employed at national level to address regulatory reliance on credit ratings. The practices outlined in this paper are therefore not meant to substitute these existing regulatory provisions, but are intended to complement them by providing additional guidance for reducing sole and mechanistic reliance on credit ratings where it occurs on a **contractual, non-regulatory, basis**.

## II. Background

12. As a first step in gathering information for this report, a questionnaire was issued by the ESAs to SCAs requesting information on the use of credit ratings by financial intermediaries under their supervision as well as alternatives for credit quality assessment other than credit ratings.
13. Following this, a Discussion Paper was issued on this subject on 23 December 2014<sup>6</sup>. The information received in response to the Discussion Paper has served two objectives:
- To add to and confirm an overview of SCAs' supervisory activities and experiences concerning contractual reliance on ratings, providing SCAs with an additional opportunity to complement the responses already received to the original questionnaire.
  - To allow supervised entities to provide feedback to the JC on their degree of contractual reliance on credit ratings and on their recourse to alternative means of creditworthiness assessments.

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<sup>6</sup> <https://www.eba.europa.eu/documents/10180/937676/JC+DP+2014+01+-+Discussion+Paper+on+Use+of+Credit+Ratings+by+Financial+Intermediaries.pdf>



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SUPERVISORY AUTHORITIES

14. Following these consultations, it was decided that the most appropriate way of ensuring a harmonised approach to the supervisory responsibilities set out in Article 5a of the CRA Regulation would be through a joint report of good supervisory practices that could complement existing national practices.

### III. Structure and Approach

15. The supervisory practices are structured into two groups. First, a set of General Practices which suggest a framework for SCAs to follow with regards to how they should monitor the use of credit ratings by their supervised entities, what alternative and complementary measures are available and how issues of nature scale and complexity can be addressed. Second, a set of Specific Practices which go into greater detail as to how mechanistic reliance on credit ratings can be assessed and mitigated with respect to the different business processes of supervised entities.
16. The set of General Practices cover:
  1. Operational procedures and governance.
  2. Alternative and complementary measures to credit ratings.
  3. Proportionality.
17. The set of Specific Practices cover six business processes where credit ratings could be most in danger of being used in a mechanistic way. The business processes covered are:
  1. Investment Decisions.
  2. Investment Advice.
  3. Investment Mandates.
  4. Collateral management and haircuts.
  5. Reference to and use of Benchmarks.
  6. Communication.
18. Throughout the paper SCAs are recommended to periodically review the usage of credit ratings by their supervised entities to assess whether they have employed adequate steps to ensure they do not solely or mechanistically rely on those ratings. In this context, the report does not recommend a minimum frequency for these reviews. It is acknowledged that periodic reviews may occur during the annual review by the SCA or at a different and institution specific frequency where that SCA employs a risk based approach to supervision.

## IV. General Good Practices

### IV.I. Rationale for Good Practice on Operational Procedures and Governance

19. The regular or periodic review of the internal assessment processes of supervised entities by SCAs, including on the basis of a risk based approach, is justified and necessary in order for supervisors to identify, prevent or mitigate any deficiencies in these internal assessment processes that could arise due to a mechanistic reliance on credit ratings. A beneficial outcome of these actions is that over time these reviews should enable supervisors to identify areas of potential systemic risk and best practice among the internal assessments of their supervised entities.

#### General Good Practice 1: On operational procedures and governance

20. **In monitoring the adequacy of the supervised entity's credit risk assessment processes and assessing the use of contractual references to credit ratings, a Sectoral Competent Authority should periodically review:**
- (i) **The supervised entity's credit risk assessment processes.**
  - (ii) **The supervised entity's use of credit ratings within its investment advice, investment decisions, investment mandates, collateral management and communications.**
  - (iii) **The use of ratings within the supervised entity's risk management processes i.e. the entities own internal risk assessment.**
  - (iv) **The additional assessment criteria the supervised entity applies to the proportion of a portfolio that is solely reliant on credit ratings.**

**In considering the frequency of the periodic review a Sectoral Competent Authority may adopt a risk based approach.**

### IV.II. Rationale for Good Practice on alternative and complementary measures to credit ratings

#### a. General considerations on internal credit risk assessments

21. Internal credit risk assessments are one possible way for supervised entities to mitigate their **contractual reliance** on credit ratings. The number of criteria referenced and the sophistication of the underlying methodology can be adapted to the individual business needs of the supervised entity. However, from the point of view of the SCA it is important that the assessment is supported by a defined and objective methodology that clearly establishes the rationale behind the inclusion, weighting and relevance of the referenced criteria.
22. The purpose of the internal credit assessments in this regard is not to replace the credit rating as a judgement of the underlying credit risk of an entity or issuance but rather to complement it by providing the

supervised entity with an additional reference point on which to base its judgement, as either credit ratings or internal credit assessments may have better characteristics depending on the specific business purpose for which they are used.

23. An internal credit assessment alternative could include various risk assessment methodologies such as:
- (i) Default statistics.
  - (ii) Financial indices.
  - (iii) Securities-related research.
  - (iv) Financial modelling.
  - (v) Analysis of underlying assets (particularly for structured finance instruments).
  - (vi) Analysis of the relevant market(s), including the degree of volume and liquidity.
  - (vii) Analysis of the structural aspects of the relevant instruments (including priorities and enhancements).
24. Some of the advantages of these internal assessment methodologies is that they reflect an institution's own analysis and expertise, and can be customised based on a particular understanding of an institution's needs. There are numerous approaches under each category of the outlined alternatives, in particular the proposed list of available methodologies is non exhaustive of the various approaches that institutions may employ. Moreover, various aspects of each category can be combined to harness the advantages of each. However, it also has to be acknowledged that setting up internal assessment processes and capabilities can be costly, depending on the type of assessment, and in order to ensure the independence and impartiality of the results should be supported by a defined and objective methodology.
25. In addition to the above, market based alternatives could also be used either on a standalone basis or as criteria within an internal credit risk assessment. Market based alternatives are based on market-based pricing information, and can include:
- (i) Bond pricing information, including credit spreads and pricing of comparable fixed income instruments and related securities.
  - (ii) Credit default-swap pricing information, including credit default-swap spreads for comparable instruments.
26. Some of the advantages of market-based alternatives are that they aggregate information among a range of market participants and reflect actual external supply and demand for particular instruments. To the extent

market-based alternatives are available, they frequently are relatively low cost and it has been demonstrated that they are generally more responsive than credit ratings.

27. In terms of disadvantages however it is recognised that at times of market stress some market based alternatives may not be available for all instruments (e.g. illiquid CDS markets) or capable (such as the pricing of similar bond issuances) of providing supervised entities with a clear reference point on which to make a judgement on the relative credit risk of an issuance or entity. For these reasons, it must be emphasised that the purpose of an internal credit risk assessment or market based alternatives is not to replace credit ratings for the purposes of a credit risk assessment but to provide an additional independent reference point on which the entity can base its credit assessment.

#### **b. Examples of Market Based Alternatives**

##### **(i) Bond Pricing Information**

28. Bond pricing information is a candidate under certain circumstances to be used as an alternative measure of the creditworthiness of an issuance or of an entity and could be used as a criteria within an internal assessment or as a standalone additional reference point. In this regard there is a range of data based on bond prices that potentially could be used such as credit spreads, pricing of comparable fixed income instruments, and pricing of related securities.
29. Credit spreads are a commonly used statistic in the financial markets. They are not difficult to calculate, although there can be difficulties in the assessment of credit spreads, depending on the structural features of bonds (e.g., call-ability, amortization) and on the availability of comparable bond pricing information. Market participants commonly calculate credit spreads on bonds based on pricing information, and construct “credit curves” for particular issuers (e.g. corporate or sovereign etc.) based on the price points derived from bonds of various maturities.
30. Credit spreads reflect market participants’ assessment of the credit risk associated with a bond. A credit spread generally describes the difference between the yield to maturity of a particular bond and the yield to maturity of a risk free bond of similar structure and maturity. For example, if a firm has issued 10-year bonds, then the credit spread could be calculated by subtracting the yield to maturity on those bonds from the yield to maturity of a corresponding risk-free bond.
31. Likewise, the pricing of comparable fixed income instruments and related securities can be used to provide market-based information about the credit risk associated with particular instruments. For example, one might obtain information about the credit spreads associated with similar and competing corporations with respect to corporate bonds, or similar countries with respect to sovereign bonds. One might obtain

information about the credit spreads associated with different bond risks during different periods of time. All of this information can be helpful in assessing the risk of a particular credit. Moreover, there is substantial evidence that bond credit spreads are correlated with actual default experience.

32. In terms of arguments against the use of bond pricing information one argument is that that bond prices are volatile, or reflect short-term market changes and therefore might not be relevant to a particular (longer term) investment or regulatory objective. While it is a debatable proposition whether bond price volatility or short-term bond price changes should be irrelevant to such objectives, market reactions, even in the short term, can be valuable indicators of information about risk. Bonds with high price volatility generally pose risks that arguably should be taken into account by both institutions and regulators, even if there is little or no credit rating volatility associated with such bonds.
33. Nevertheless, to the extent there are concerns about price volatility or short-term price changes, those concerns can be overcome by using statistical techniques, such as moving averages of available prices. For example, the use of a 30-day or 90-day moving average of bond credit spreads or bond pricing information.
34. Moreover, a longer-term moving average would not be subject to the same drawbacks with respect to volatility and the short-term nature of bond prices. On the contrary however moving averages based on too long time periods may not be sufficiently responsive to signal relevant market information. Hence in this context market participants should select the optimal time length to use depending on the specific business application, and could implement periods of weeks, months, or even longer if appropriate.

#### **(ii) Credit Default Swap Pricing Information**

35. In addition to bond pricing information, for many counterparties there is pricing information for credit default swaps, or CDS. In a typical CDS transaction, one counterparty (the buyer of protection) agrees to pay a periodic premium to the other counterparty (the seller of protection). In return, the seller of protection agrees to compensate the buyer of protection if a reference entity specified in the CDS contract experiences a default or similar “credit event.” For simple CDSs, the reference entity might be a corporation or government entity. For more complex CDSs, the reference entity might be a portfolio of structured financial instruments. Parties usually document the various CDS terms through a standard ISDA or similar form of agreement.
36. CDS ‘prices’, as measured in the market, represent the size of the premium paid by the buyer of protection and are generally known as CDS “spreads.” CDS spreads change over time based on supply and demand for particular CDS contracts. CDS spreads are analogous to insurance premiums and similarly reflect market participants’ assessment of the risk of a default or credit event associated with the underlying obligation.

37. Where CDSs are widely and deeply traded, they help to reflect market information about the credit risk of underlying financial obligations. CDS markets generally reflect valuable information, and reflect that information more promptly than changes in credit ratings, even during periods of intense market discord. For example, the CDS spreads increase during 2007 and 2008 as information became available, may have suggested that the credit quality of financial institutions was decreasing.

**General Good Practice 2: On the methodologies to substitute or complement credit ratings**

38. SCAs should encourage their supervised entities, taking into account their nature, scale and complexity, to develop internal credit risk assessments (within which market based pricing information may be counted as a criteria) or, where this is not possible, consult market based alternatives on a standalone basis to enable them to mitigate mechanistic reliance on credit ratings. Internal credit risk assessments should be tailored to the specific business requirements of the supervised entity, and while it is not excluded that credit ratings may also be counted as criteria, any internal credit risk assessment should be supported by a defined and objective methodology that establishes the rationale behind the inclusion, weighting and relevance of the referenced criteria.

**IV.III. Rationale for Good Practice on proportionality**

39. The goal of the practices outlined in this paper is the mitigation of sole and mechanistic reliance on credit ratings. As such, supervisors should be mindful that for reasons of cost or expertise some supervised entities may encounter difficulties in developing an internal assessment that incorporates a comprehensive set of potential alternative criteria. For this reason, SCAs should have due regard to the nature, scale and complexity of the relevant supervised entity when assessing the use of alternative assessment criteria.

**General Good Practice 3: On Proportionality**

40. With due regard for the principle that all supervised entities avoid sole and mechanistic reliance on credit ratings, SCAs should maintain a proportional approach when assessing the internal processes employed as alternatives or as complements to credit ratings and should avoid adopting a 'one size fits all' approach. In particular, the following hierarchy may be used as guidance assuming that less sophisticated entities – who currently use credit ratings for the purposes of their credit risk assessments - should at least implement the first items with the other items being implemented proportionally by entities that engage in more complex or large volume of transactions.
- (i) Where the business model and operations are of a level of complexity where the use of credit ratings in credit risk assessments is justified to a greater degree (less sophisticated entities):

- a. supervised entities should record the credit rating, the name and type of the underlying instrument, industry sector, geographical location and seniority;
  - b. supervised entities should, where economically and technically possible, compare assessments provided by different credit rating agencies;
  - c. supervised entities should compare their own risk assessment with those provided by external rating agencies.
- (ii) Where the business model and operations are of a level of complexity where the use of credit ratings is justified to a lesser degree (more sophisticated entities):
- a. SCAs should encourage their supervised entities to have internal processes in place to collect and analyse publicly available financial data and market based pricing information to make their own credit assessment;
  - b. SCAs should encourage their supervised entities to have internal processes in place to ensure their own credit assessments, where related to contractual obligations, are supported by defined and objective methodologies.

## V. Specific Good Practices

41. This section outlines some of the ways credit ratings can be used within the specific business processes of financial institutions. It discusses how mechanistic reliance on ratings may arise within these processes on a contractual basis and suggests practices that SCAs may employ to mitigate any such reliance on credit ratings.
42. These specific practices should be read within the context of the general practices, so that SCAs may accommodate the differing nature, scale and complexity of their supervised entities.

### V.I. Investment Decisions

43. Historically, many financial institutions have relied on credit ratings in making investment decisions. In theory, credit ratings are one of the more straightforward and accessible means of addressing information asymmetry endemic in financial markets, providing investors with relevant information on a company, financial instrument, or country and a first approximation of creditworthiness.
44. However, it is relevant that even CRAs themselves agree that investment decisions should not exclusively, or even primarily, be based on credit ratings. Indeed, it is also relevant to consider the extent to which credit analysts should derive their own conclusions as opposed to basing them on a second-hand view such as a CRA rating.
45. With regards to their value as inputs in the investment decision process, some institutions are of the view that as CRA rating actions often lag market indicators there is limited utility in ratings forming part of the investment decision making process. Instead, these institutions refer to alternatives such as credit spreads or other market signals as part of their investment decision.
46. In terms of a potential compromise, an internal model could include the optionality to refer to credit ratings as one of the many factors feeding into the investment decision. This approach could be particularly useful for smaller institutions that cannot afford a substantial budget or personnel for making investment decisions, and in particular credit decisions which require a significant investment in human resources, technology, and research. While it is relevant to raise the issue of cost in relation to such an approach, it should be recognized that certain market data, including CDS or credit spreads, could be incorporated where available and become part of the investment decision process at relatively low cost.
47. Even in such a scenario in which the reliance on credit ratings is mitigated by reference to other factors the importance of transparency in the investment decision process should also be stressed. To the extent an institution continues to rely on credit ratings for investment decisions, that fact should be disclosed to the

relevant parties in order that they may have an understanding of the basis on which investment decisions are taken.

### **Specific Good Practice 1: Investment Decisions**

48. **SCAs should encourage their supervised entities to ensure that credit risk assessments relating to investment decisions are not based solely or mechanistically on credit ratings. SCAs should encourage supervised entities to use their own internal assessments and/or market based pricing information as a complement or substitute to credit ratings when conducting credit risk assessments relating to investment decisions.**
49. **For the purposes of supporting their internal assessments SCAs could encourage their supervised entities to consider additional assessment criteria, such as:**
- (i) Pricing of comparable fixed income instruments and related securities.**
  - (ii) Credit default-swap pricing information. Credit default-swap spreads for comparable instruments.**
  - (iii) Default statistics.**
  - (iv) Financial indices.**
  - (v) Securities-related research.**
  - (vi) Financial modelling.**
  - (vii) Analysis of underlying assets (particularly for structured finance instruments).**
  - (viii) Analysis of the relevant market(s), including the degree of volume and liquidity.**
  - (ix) Analysis of the structural aspects of the relevant instruments (including priorities and enhancements).**

### **V.II. Investment Advice**

50. Where financial intermediaries continue to make reference to credit ratings as part of their investment advice it is often highlighted that this is partly for the reason that credit ratings are a useful tool for communicating in a “common language”.
51. This ease of comparability aside however, the same concerns described with respect to investment decisions would also apply to any investment advice that relied on credit ratings. Indeed, when one fully considers the consequences of a mechanistic reliance on credit ratings in the provision of investment advice, in which rating actions lead directly to advice to buy or sell, the problems associated with ‘herding’ are particularly likely to be present.

52. Whereas one potential approach is for investors to be encouraged to do their own due diligence and not rely exclusively on credit ratings, another is for the institutions providing the advice to develop internal models that do not rely on credit ratings in a mechanistic fashion. However, similar to the mitigation of reliance in investment decisions, when considering the best approach in this area the size and sophistication of the institution should be taken into account.

#### **Specific Good Practice 2: Investment Advice**

53. **SCAs should encourage their supervised entities to ensure any credit risk assessment included as part of investment advice is not based solely or mechanistically on credit ratings. SCAs should, monitor what steps their supervised entities have taken to ensure the credit risk assessment underpinning any investment advice does not solely or mechanistically rely on credit ratings.**
54. **Depending on the level of sophistication of the underlying client, SCAs should recommend their supervised entities to describe the credit risk associated with a particular investment with reference to a range of factors, such as:**
- (i) Types of instrument.**
  - (ii) Industry sector.**
  - (iii) Geographical location.**
  - (iv) Seniority.**
  - (v) Comparison of external ratings.**
  - (vi) Available market data.**
  - (vii) Securities-related research.**
  - (viii) Analysis of underlying assets (particularly for structured finance instruments).**
  - (ix) Analysis of the relevant market(s), including the degree of volume and liquidity.**
  - (x) Analysis of the structural aspects of the relevant instruments (including priorities and enhancements).**

#### **V.III. Investment Mandates**

55. An investment mandate is a reference to the agreement between the client and the asset manager that arises in the case of discretionary portfolio management. One of the aspects of this mandate is the level of risk a client is willing to take. One way this risk can be described is through a required minimum credit rating for investments.
56. While some portfolio managers are of the view that they should be entitled to include reference to credit ratings within investment mandates owing to reasons of client preference and ease of understanding, it

would be desirable to see a reduction of reliance on credit ratings within investment mandates through the inclusion of additional and alternative metrics in order to avoid the underestimation of credit risk and the potential for pro-cyclical behaviour.

57. Similarly, it would be beneficial to ensure credit ratings are not relied upon with regard to the setting of credit risk policy limits and investment mandate restrictions for portfolio managers. In these cases, credit ratings often define the “universe” of securities that assets managers can choose from. This kind of reliance appears to be largely mechanistic and is potentially problematic.
58. With regards to the employment of internal assessments or alternative indicators it is important to consider the capacity of many portfolio managers to individually assess credit risk and establish internal risk limit systems. In other words, whereas some portfolio managers have the resources, scale, and capacity to understand the complexities of designing independent credit assessment systems, there are others who cannot afford to incur the expenses associated with such internal credit assessment.
59. In cases where the portfolio manager lacks the ability to mitigate reliance on ratings via an internal assessment, reference to alternative metrics such as market based pricing information is advisable in order to mitigate mechanistic reliance on credit ratings.

### **Specific Good Practice 3: Investment Mandates**

60. **SCAs should encourage their supervised entities to ensure that investment mandates do not reference credit ratings as an explicit trigger or include reference to a minimum credit rating as part of a mandate’s credit risk assessment criteria. SCAs should encourage their supervised entities to review existing mandates to which they or their clients are party in order to identify any potential instances of mechanistic reliance on credit ratings. As an alternative, SCAs should encourage their supervised entities to reference either market-based measures or the results of an internal assessment.**

### **V.IV. Collateral management and haircuts**

61. Bilateral agreements for financial collateral are one area of the contractual agreements that are most prone to sole or mechanistic reliance on external ratings. First of all, two counterparties have to define a list of eligible collateral covering a set of securities. Typically, such a list is as broad as possible to allow flexibility in the financial collateral posted and collected, but it is restricted to guarantee the credit quality of the collateral itself. As explained in the previous sections, the external ratings become the common language to ensure such credit quality at all times and help to avoid disputes.

62. Since collateral contracts are binding agreements, setting minimum credit quality by reference to external ratings is then the easiest approach. Similarly, risk sensitive volatility adjustments to the value of the collateral, i.e., haircuts, are commonly set in reference to credit ratings.
63. The sole or mechanistic use of credit ratings in this area may generate systemic and micro-prudential concerns. On the one hand, the fact that securities collected as collateral have high credit ratings does not exclude that these are positively correlated with the collateral provider ('wrong-way risk'). By the systemic point of view, the downgrade of a particular issuer may make those securities ineligible for a large part of counterparties at the same time ('cliff-effect'). This may not only exacerbate the stress for a particular issuer when it is already in financial distress, but also produce a loss in market value that exceeds the haircut previously associated with this issuer.
64. SCAs should consider these elements when reviewing the procedures around collateral management. The SCA may expect that these problems are solved in a different manner depending on the size and complexity of the collecting party.
65. It should be noted that some regulations<sup>7</sup> allow the use of internal credit assessment models, where approved by the supervisors, not only for the party developing the model but also for the other counterparty. Although this approach may not be widely used, it would help to avoid cliff effects as internal models would be updated at different times. The current level of disclosure requirements may be considered helpful to allow counterparties the necessary degree of understanding of the methodology, even though one of the two would not have access to the complete information. Wrong way risk remains the responsibility of the collecting party.
66. Assuming that counterparties relying on financial collateral do refer to credit ratings in their contractual agreements, there are other ways to avoid cliff-effects. For example, the introduction in the contractual agreements of a 'grace period' for the collateral eligibility after downgrade and some diversification requirements.
67. As the risk of cliff effects may not be sufficiently mitigated by the introduction of internal credit assessments, these draft RTS<sup>8</sup> also allow the minimum level of credit quality set out in the contractual agreement to be exceeded for a 'grace period' following a downgrade of the issuer or security. This should be conditional on the counterparty starting a well-defined process to replace the collateral, but should avoid a general sell-off of that particular security.

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<sup>7</sup> <https://www.eba.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-18%29.pdf/fb0b3387-3366-4c56-9e25-74b2a4997e1d>

<sup>8</sup> See footnote 9.

68. The danger of an unexpected loss in value of the collateral due to the cliff-effect can also be mitigated by introducing concentration limits in the collateral agreements. Where the rating provided by a CRA resulted in inappropriate margining, diversifying the collected collateral by type of product, issuer, geographical location and external rating provider would provide a certain level of mitigation.
69. Similarly, haircuts can be set with reference to credit ratings and become prone to sole or mechanistic reliance. Ideally, haircuts should be subject to internal modelling based on market data. Taking into account the proportionality principle, however, SCAs may consider the use of external ratings for setting the haircuts where collateral is subject to additional controls, such as the diversification of collected collateral and the possibility to apply 'grace periods' to the posted or collected collateral.

#### **Specific Good Practice 4: Collateral management and haircuts**

70. **SCAs should encourage their supervised entities to ensure that collateral agreements do not rely solely on credit ratings as the determining factor for the eligibility of collateral within collateral agreements. As an alternative and with respect to the nature scale and complexity of the institutions, SCAs should encourage the use of internal credit assessments if these are acceptable by both counterparties and if they are subject to the supervisory approval.**
71. **In addition, SCAs should encourage the estimation of volatility adjustments to the value of the collateral ('haircuts') that are based on observable market data.**
72. **For those supervised entities that choose to maintain the use of references to credit ratings, SCAs should encourage that they include in the agreements:**
- (i) Some diversification requirement; and**
  - (ii) the possibility to apply a 'grace period' before making some collateral ineligible;**

#### **V.V. Reference to and use of Benchmarks**

73. Financial intermediaries can make use of benchmarks as independent reference points for judging the performance of a portfolio or an investment's performance. Credit ratings can feature as part of the methodology for various benchmarks, typically as criteria for inclusion. To the extent such benchmarks are used as independent reference points by supervised entities to judge investment performance or credit risk this introduces the potential for providing institutions with a distorted or misleading reference point.

#### **Specific Good Practice 5: Reference to and Use of Benchmarks**

74. **SCAs should encourage their supervised entities to avoid relying upon benchmarks, whose methodologies mechanistically rely on credit ratings as the only reference points for their investment decisions or as determining factors within their own credit risk assessment processes. SCAs should encourage their supervised entities to conduct a review of their business processes to identify where any such reliance occurs. Should this occur, SCAs should encourage the institution to familiarise itself with the benchmark’s construction and methodology to ensure any potential mechanistic reliance is identified and mitigated.**

#### **V.VI. Communication**

75. Credit rating actions often generate attention in the media. To varying degrees, financial institutions can refer to credit rating changes in their marketing material, research reports or supporting material accompanying contractual agreements. While the benefits of credit ratings serving as a “common language” for communicating with clients and investors are recognised, it is advisable that financial institutions avoid referring to credit ratings within such documents in a manner that could lead to the rating being presented as a definitive and objective measurement of credit risk.
76. To the extent possible when credit ratings are referred to in such communications, which admittedly are more general and difficult to define than communications relating to investment advice, other relevant illustrating metrics or factors should also be included. This should in particular occur to avoid that contractual agreements may be de facto based on the basis of sole or mechanistic reliance on credit ratings.

#### **Specific Good Practice 6: Communication**

77. **For purposes of communicating with clients and investors, SCAs should encourage their supervised entities to refrain from referencing credit ratings as a key or recommending attribute when describing the credit risk associated with a portfolio or an instrument. Instead, SCAs should, depending on the level of sophistication of the underlying client, recommend their supervised entities to describe the credit risk associated with a particular investment with reference to a range of factors, such as:**
- (i) Types of instrument.**
  - (ii) Industry sector.**
  - (iii) Geographical location.**
  - (iv) Seniority.**
  - (v) Comparison of external ratings.**
  - (vi) Available market data.**
  - (vii) Securities-related research.**
  - (viii) Analysis of underlying assets (particularly for structured finance instruments).**
  - (ix) Analysis of the relevant market(s), including the degree of volume and liquidity.**



JOINT COMMITTEE OF THE EUROPEAN  
SUPERVISORY AUTHORITIES

**(x) Analysis of the structural aspects of the relevant instruments (including priorities and enhancements).**

## VI. Conclusions

78. Credit ratings are part of the financial culture. However, where credit ratings are most embedded in the decision making process, they also are the most potentially problematic. Ideally, institutions and investors should find independent means of assessing the risks of different investments within different categories. The goal of these practices is that they can be used by SCAs to encourage their supervised entities to reassess their approach to credit risk, with the least disruption possible.
79. The practices for the various categories of use are designed to take into account a range of institutional needs and capabilities. It is important that SCAs encourage the adoption of additional independent reference points such as internal credit assessments and/or market based alternative measures by their supervised entities to ensure that any contractual sole and mechanistic reliance on credit ratings is avoided, together with any potential issues of systemic risk that could arise from such reliance.