ANNEX I

MOODY'S INVESTORS SERVICE

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COMMENTS ON EUROPEAN SUPERVISORY AUTHORITIES JOINT CONSULTATION PAPER ON PRIIPS KEY INFORMATION DOCUMENTS REGULATORY TECHNICAL STANDARDS (JC 2015 073)

Moody's Investors Service ("**MIS**") wishes to thank the European Supervisory Authorities (the "ESAs") for the opportunity to provide comments on the Joint Consultation Paper on PRIIPs[1] Key Information Documents and Draft Regulatory Technical Standards (the "**Joint Consultation Paper**"). MIS supports initiatives to improve the information available to investors and market participants. We believe that the market is best served when there are more, not fewer, available tools and resources for measuring and assessing credit risk. We are concerned, however, that the Joint Consultation Paper proposes that credit ratings form the basis of the credit risk assessment disclosed to retail investors in PRIIPs Key Information Documents (the "**KID**"). This approach is concerning because: (1) it may inadvertently misconstrue credit ratings as investment advice; (2) it positions credit ratings for use by the retail sector; and (3) it is inconsistent with the broader public policy agenda for reducing regulatory use and reliance on credit ratings. Below, we discuss each point in turn.

I. Credit Ratings are not Investment Advice

Credit ratings are forward-looking opinions about credit risk. MIS credit ratings address the probability that a financial obligation will not be honored as promised (i.e. probability of default), and any financial loss suffered in the event of default. [2] The role credit ratings play in the capital markets has been scrutinized over the past few years. That ratings are useful, and have fulfilled a market need, is widely accepted.

> *"CRAs play an important role and their ratings can appropriately be used as an input to firms' own judgement as part of internal credit assessment processes".*[3]

While credit ratings can play a useful role in enabling financial market professionals to assess credit risk, credit ratings do not address many other significant factors in the investment decision process, including, for example, price, term, likelihood of prepayment, liquidity risk and relative valuation. The likelihood that debt will be repaid is just one relevant consideration, and in many

[1] Packaged Retail and Insurance-based Investment Products.

[2] Analysis of these two factors together forms the basis of MIS' expected loss ("El") approach to credit risk. Obligations rated on Moody's global rating scale measure long-term credit risk, and our analytical focus is on the key factors that drive each issuer's ability over the long term to meet its obligations as they come due.

[3] Financial Stability Board, Principles on Reducing Reliance on CRA Ratings, 27 October 2010, pg. 2.

cases may not be the most important consideration, in an experienced investor's decision-making process for buying credit-sensitive securities.

MIS consistently discourages market participants from using our ratings as indicators of price, as measures of liquidity, or as recommendations to buy, sell or hold securities – all of which are regularly influenced by factors unrelated to credit. For example, credit ratings issued by MIS are accompanied by a disclaimer containing the following clear statement:

> *"Moody's credit ratings and Moody's publications are not intended for use by retail investors and it would be reckless and inappropriate for retail investors to use Moody's credit ratings or Moody's publications when making an investment decision. If in doubt you should contact your financial or other professional adviser."*

II. Credit Ratings are Intended for Professional Investors, not the Retail Sector

MIS is concerned that the Joint Consultation Paper proposes to leverage credit ratings to inform retail investors about credit risk. Credit ratings published by international credit rating agencies are intended for use solely by financial market professionals. Retail investors are considered to be at greater risk than financial market professionals of over-relying on credit ratings without performing an independent assessment of the appropriateness of, or risks relating to, an investment product. MIS intends for our ratings to promote dialogue among institutional investors and financial market professionals, who we expect will assess our opinions relative to their own credit judgment.

Credit ratings condense a significant amount of analysis into a symbol system and are, accordingly, appropriate for use only by investors who understand the nature, scope and purpose of the credit rating issued. Significantly, credit ratings are not, and are not intended to be relied upon as, a suitability test or recommendation. Rather, credit ratings communicate one perspective about the future credit risk of debt issuers or securities relative to other debt issuers and securities and are not intended to be used in any way as a basis for retail investors to make an investment decision.

Appropriately, the Regulation[4] does not require the use of credit ratings in the KID for PRIIPs[5]. MIS does not object to use of credit risk measures for retail investors, but we caution against disclosure mechanisms that do not fully reflect the complexity of the investment process. Here, the summary risk indicator, substantially underpinned by external credit ratings[6], seeks to boil down and communicate information on investment risk in a "simple graphical fashion".[7] This approach may unintentionally lead retail investors to believe that the investment process is simple, and that a comprehensive evaluation of risks is unnecessary. As alternative, we encourage the ESAs to develop an approach that incorporates information from a variety of

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[4] Regulation (EU) No 1286/2014.

[5] Before a PRIIP is made available to retail investors, the PRIIP manufacturer shall draw up for that product a KID and must publish the KID on its website. Regulation (EU) No 1286/2014. The KID is intended improve the information available to retail investors and enable comparability of risks between different PRIIPs. Joint Consultation Paper, Draft RTS, Recital 5. The information on risks is intended to be aggregated and presented in a simple graphical fashion through a single summary risk indicator. *Id.*

[6] While the proposal does not call for individual credit ratings to be displayed in the KID, it does call for external credit ratings to form the basis of the credit risk assessment provided to retail investors through the aggregated summary risk indicator. *See* Joint Consultation Paper, Draft RTS, Annex II, Part 2.

[7] Joint Consultation Paper, Draft RTS, Recital 5.

credit risk measures. These include, for example, market-based indicators such as market implied ratings and credit default spreads. By leveraging these and other available tools, the KID may provide retail investors with a more complete understanding of the product and the nature of the credit risk.

We also urge the ESAs to ensure that there is a clear disclosure in the KID to the effect that, although credit ratings may have been used to formulate certain information provided in the KID, credit ratings are not designed for, or intended for use by, retail investors and it would be inappropriate for retail investors to rely on credit ratings in making investment decisions.

III. The PRIIPs Proposal is Inconsistent with International Policy

The proposal set forth in the Joint Consultation Paper to leverage credit ratings for PRIIPs is wholly inconsistent with EU and broader international regulatory policy objectives to reduce reliance on credit ratings.

One of the primary objectives of the EU Regulation on credit rating agencies[8] (the "**CRA Regulation**") is to reduce the risk of over-reliance on credit ratings[9]. Specifically, the CRA Regulation restricts the ESAs from "refer[ing] 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."[10] The CRA Regulation also calls for the European Commission to review of all references to credit ratings in EU law with a view towards eliminating by 2020 those with potential to trigger sole or mechanistic reliance on credit ratings[11].

The provisions in the CRA Regulation are in line with the Financial Stability Board's ("FSB") principles to reduce reliance on credit ratings in standards, laws, and regulations.[12] The FSB principles are informed by three widely-accepted observations. First, because the mechanical use of ratings in regulation could have a detrimental effect on the markets – such as leading to herding behaviour by regulated entities – regulators should reduce instances of hardwiring ratings into oversight regimes. Second, ratings should not be perceived or treated as a "substitute"[13] for market participants' own assessment of credit or other risks. Finally, policymakers could inadvertently encourage broader market reliance on credit ratings through the overall "design" of regulatory regimes.[14]

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8 Regulation (EC) No 1060/2009 of the European Parliament and of the Council as amended by Regulation (EU) No 513/2001 and Regulation (EU) No 462/2013.

9 *See* Recital 49 of the CRA Regulation.

10 Article 5b of the CRA Regulation.

11 Article 5c of the CRA Regulation states, in part:

> …the Commission shall continue to review whether references to credit ratings in Union law trigger or 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 with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and implemented.

12 *See* Financial Stability Board, Principles on Reducing Reliance on CRA Ratings, 27 October 2010.

13 *"While references to CRA ratings in internal limits, credit policies and mandates can sometimes play a useful role as broad benchmarks for transparency of credit policies, they should not substitute for investment managers' own independent credit judgments and that should be clear to the market and customers". Id.*

14 *Id.*

The proposal in the Joint Consultation Paper undermines these objectives by further embedding the use of credit ratings in regulation, and by requiring disclosure to retail investors of a summary risk indicator calculated by reference to credit ratings. The use of credit ratings in the proposed credit assessment methodology for the KID raises two significant concerns. First, by design, the proposed credit risk assessment is lock-step process driven almost entirely by credit ratings without meaningful supplemental input. Credit ratings are most useful when they are used to supplement and enhance market participants' own assessment of credit risk. Credit ratings are opinions about credit risk, and although they play an important role in the global capital markets, they are but one "tool in the toolbox". They should not be used in isolation, nor should they operate as a trigger to require a certain course of conduct. It should be borne in mind, in this context, that retail investors are considerably more likely than financial market professionals to place reliance on a summary risk indicator or credit rating, without performing an independent credit assessment.

Second, the methodology hardwires into regulation a requirement that PRIIP manufacturers obtain a credit rating, or be subject to a default credit assessment which is no higher than a mid-range credit rating. The proposed methodology treats credit ratings as commodities and interchangeable for regulatory purposes.[15] This commoditization of credit ratings can affect the traditional incentives to differentiate among CRAs based on the ratings' credibility, and can encourage issuers to engage rating shopping.

We would be pleased to discuss our views in more detail with you at your convenience.

Yours sincerely

Olivier Beroud
Regional Head: Europe, Middle East and Africa

[15] We also note that the Draft RTS contains a typographical error that incorrectly references an MIS credit rating of 'BBB'. Joint Consultation Paper, Draft RTS, Annex II, Part 2, Item 68. We believe the intended MIS credit rating is 'Baa'.