



JOINT COMMITTEE OF THE EUROPEAN
SUPERVISORY AUTHORITIES

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Discussion Paper

The Use of Credit Ratings by Financial Intermediaries Article 5(a) of the CRA Regulation



JOINT COMMITTEE OF THE EUROPEAN
SUPERVISORY AUTHORITIES

Responding to this paper

EBA, ESMA and EIOPA (the ESAs) invite comments on all matters of this discussion paper and, in particular, on the specific questions listed in Annex I. Comments are most helpful if they:

- indicate the number of the question to which the comments relates;
- indicate the name and business of the contributor;
- respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternative ESMA, EBA, EIOPA should consider.

Comments should reach us by 27 February 2015.

All contributions should be submitted online at www.esma.europa.eu under the heading “Your input/Consultations”.

Publication of responses

All contributions received will be published on the ESAs’ websites following the end of the consultation period, unless otherwise requested. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. Note also that a confidential response may be requested in accordance with ESAs’ rule on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by the ESAs’ Board of Appeal and the European Ombudsman.

Data protection

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Who should read this paper?

This discussion paper should be read by all market participants who use external credit ratings (as defined in Article 3(1)(a) of the CRA Regulation) in internal creditworthiness assessments. This includes Credit Institutions, Insurance and Reinsurance Entities, Investment firms, Investment managers, Central Counterparties and the National Authorities supervising them.

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Acronyms

AFM	Netherlands Authority for the Financial Markets
AIFMD	Alternative Investment Fund Managers Directive - Directive 2011/61/EU
BCBS	Basel Committee on Banking Supervision
CCP	Central Counterparties
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CIS	Collective Investment Scheme
CIU	Collective Investment Undertaking
CRA	Credit Rating Agency
CRA Regulation	Credit Rating Agencies Regulation - Regulation (EC) No 1060/2009
CRD IV	Capital Requirements Directive - Directive 2013/36/EU
CRR	Capital Requirements Regulation - Regulation (EU) No 575/2013
EBA	European Banking Authority
EC	European Commission
ECAI	External Credit Assessment Institution
EIOPA	European Insurance and Occupational Pensions Authority

EMIR	European Market Infrastructures Regulation - Regulation (EU) No 648/2012
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ETF	Exchange Traded Fund
FSB	Financial Stability Board
HQLA	High Quality Liquidity Assets
IOSCO	International Organization of Securities Commissions
IORP	Institutions for Occupational Retirement Provision
IORP Directive	Institutions for Occupational Retirement Provision Directive - Directive 2003/41/EC
JC	Joint Committee
MMI	Money Market Instrument
NRSRO	Nationally Recognized Statistical Rating Organizations
OTC	Over the Counter
RTS	Regulatory Technical Standards
SCA	Sectoral Competent Authority
SEC	US Securities and Exchange Commission
SFI	Structured Finance Instrument
SWOT	Strengths, Weaknesses, Opportunities and Threats
UCITS	Undertakings for Collective Investment in Transferable Securities

UCITS Directive Undertakings for Collective Investment in Transferable Securities Directive - Directive
2009/65/EC

I. Executive Summary

Reasons for publication

1. Art. 5b(1) of the CRA Regulation – as amended by the CRA3 Regulation¹ -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 reviewed and removed, where appropriate, all such references to credit ratings in existing guidelines and recommendations. The scope of Article 5b(1) includes not only the guidelines adopted by the three ESAs since their establishment in January 2011, but also all the guidelines and recommendations adopted by CEBS, CEIOPS, and CESR, and still in force.
2. In compliance with CRA3, EBA, EIOPA and ESMA decided to review and where appropriate remove references to ratings in a coordinated way through the Joint Committee of the ESAs.
3. On 6 February 2014 the three ESAs published their Final Report on Mechanistic references to credit ratings in the ESAs' guidelines and recommendations (JC 2014 004)². The purpose of this report was to set out responses received to the feedback statement within the Joint Consultation Paper JC-CP-2013-02 published by the three ESAs on 7 November 2013³, as well as to provide a definition for “sole or mechanistic reliance” mentioned in Art 5b(1). The report also listed provisions from the EBA, EIOPA and ESMA guidelines and recommendations containing rating references that should not be viewed as “sole or mechanistic”. Finally the report listed a set of provisions that require revision according to the ESAs.
4. The JC of the ESAs also decided to start working on a second set of guidelines to guarantee a harmonised application of the modalities for SCAs to monitor contractual recourse to ratings by financial intermediaries and encourage mitigation of such recourse to ratings with a view to reducing sole and mechanistic reliance

¹ [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.](#)

² http://www.esma.europa.eu/system/files/jc_2014_004_final_report_mechanistic_references_to_credit_ratings_rect.pdf

³ http://www.esma.europa.eu/system/files/jc-cp-2013-02_mechanistic_references_to_credit_ratings.pdf

on such credit ratings. The context for this process is set out in Recital 9 of CRA3 which states that “over-reliance on credit ratings should be reduced and all the automatic effects deriving from credit ratings should be gradually eliminated. Credit institutions and investment firms should be encouraged to put in place internal procedures to make their own credit risk assessment and should encourage investors to perform a due diligence exercise. In addition, Recital 9 sets out that financial institutions “should avoid entering into contracts where they solely or mechanistically rely on credit ratings and should avoid using them in contracts as the only parameter to assess the creditworthiness of investments or to decide whether to invest or divest”.

5. As stated in Article 5a of the CRA Regulation, SCAs shall monitor that credit assessment processes and reference to ratings in the investment policies by financial intermediaries mentioned in Art 4(1) of the CRA Regulation do not rely mechanistically on ratings, and where appropriate encourage mitigation of the impact of contractual references to ratings.
6. Moreover, the CRA 3 package contained amendments to the IORP, UCITS and AIFM Directives⁴, requiring SCAs to monitor reference to ratings in the investment policies and where appropriate encourage mitigation of their impact, with a view to reducing sole and mechanistic reliance on such credit ratings. EU Member States are to adopt the required internal legislation by 18 months after entry into force of CRA3 in June 2013.
7. Under the terms of Article 3(1)(r) of the CRA Regulation, SCAs mean the national competent authorities designated under the relevant sectoral legislation for the supervision of:
 - Credit institutions.
 - Investment firms.
 - Insurance undertakings.
 - Reinsurance undertakings.
 - Institutions for occupational retirement provision (IORPs).
 - Management companies.
 - Investment companies.

⁴ [DIRECTIVE 2013/14/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 May 2013](#)

- Alternative investment fund managers.
 - Central counterparties.
8. With a view to gathering a first set of information, a questionnaire was issued by the ESAs to SCAs concerning the use of credit ratings by financial intermediaries under their supervision and possible alternatives for credit quality assessment other than credit ratings. The questionnaire was prepared on the basis of an initial input provided by the AFM and further developed thanks to the contribution of the European Commission.
9. Such preliminary information has been used to draft the present Discussion Paper with two objectives:
- Establishing a preliminary overview of SCAs' supervisory activities and experiences concerning contractual reliance on ratings and providing SCAs with an opportunity to complement the responses already received to the original questionnaire.
 - Allowing supervised entities to provide a feedback to the JC on their degree of contractual reliance on credit ratings and on their recourse to alternative means of creditworthiness assessments.

Contents

10. Section II provides an international context to the reduction of contractual reliance on external credit ratings for the conduct of creditworthiness assessments. This includes an overview of the work conducted by the Financial Stability Board with regards to its principles and roadmap for the reduction of reliance by authorities and financial institutions on credit rating agencies. The work of IOSCO Committee 5 in the area of reducing reliance is also outlined, with details of its recently published Consultation Report on Good Practices on Reducing Reliance on CRAs. The Basel Committee on Banking Supervision's review on the Basel securitisation framework is described while a short non-official synopsis of the final rule adopted by the US SEC on 8 January 2014 on the removal of certain references to credit ratings under the Securities Exchange Act of 1934 is also provided. Finally, a summary of the AFM report on the use of credit ratings is included for means of illustration of the work which has taken place so far at national level within the EU.
11. Section III provides a summary overview of responses received from SCAs to the questionnaire issued by the ESAs on the use of credit ratings by financial intermediaries. The summary is broken down by type of financial intermediary and looks to address responses under the headings of use of external ratings, actions taken and harmonisation, challenges in promoting alternatives, alternatives to external ratings and, where applicable, references in regulations and guidelines. While the presence of reliance on credit ratings is acknowledged in relation to the area of central bank refinancing operations, this area issue is not addressed

in detail at this stage, as for the moment it is not deemed as a contractual reliance. Further discussion on the topic may however be provided at a subsequent stage following consideration of responses received.

12. A list of questions directed at financial market participants and SCAs is provided in Annex 1.

Next steps

13. The current Discussion Paper will be open for comments until 27 February 2015.

14. The evidence gathered from the replies to the Discussion Paper will be used for the drafting of the JC guidelines on reducing contractual reliance on ratings. In H1 2015 ESMA will issue a public Consultation Paper containing a summary of the consultation responses to the Discussion Paper and a first draft of the guidelines. The final guidelines are expected to be adopted by the JC of the three ESAs by Q3 2015 and then ratified by the three ESAs.

II. International Developments in Reducing Reliance on Ratings

II.1. FSB Principles and Roadmap

15. On 27 October 2010 the FSB endorsed principles to reduce the reliance of authorities and financial institutions on credit ratings⁵. The principles cover five types of financial market activity: prudential supervision of banks; policies of investment managers and institutional investors; central bank operations; private sector margin requirements; and disclosure requirements for issuers of securities. The goal of the principles is to reduce the cliff effects from CRA ratings that can amplify pro-cyclicality and cause systemic disruption. The principles call on authorities to do this through:

- Removing or replacing references to CRA ratings in laws and regulations, wherever possible, with suitable alternative standards of creditworthiness assessment.
- Expecting that banks, market participants and institutional investors make their own credit assessments, and do not rely solely or mechanically on CRA ratings.

⁵ [FSB Principles for Reducing Reliance on CRA Ratings](#).

16. The FSB asked standard setters and regulators to consider next steps that could be taken "over a reasonable timeframe" to translate the principles into policy approaches tailored to specific financial sectors and market participants.
17. In November 2012, the FSB published a roadmap⁶ to accelerate the implementation of the FSB Principles to reduce reliance on CRA ratings. The FSB roadmap set out a timeline with concrete actions for jurisdictions with a view to implementing the FSB Principles. As part of the roadmap, a peer review was conducted by the FSB to assess the progress of jurisdictions with the implementation of the roadmap.
18. In its final report⁷, the peer review concluded that progress toward the removal of references to CRA ratings from standards, laws and regulation has been uneven across jurisdictions and the financial sectors. In addition, the peer review considered that removing references to CRA ratings from laws and regulations is only one step from a broader effort to reduce reliance on ratings. In particular, mechanistic reliance on CRA ratings can also come from market practices and private contracts. Furthermore, the peer review outlined that the key challenge will be developing alternative standards of creditworthiness and processes so that external credit ratings are not the sole input to credit risk assessment.
19. The peer review suggested that national authorities need to focus on encouraging stronger internal credit risk assessment practices. In some circumstances, this may cover a fully independent risk assessment, and in other circumstances, this may allow using CRA ratings as one indicator, amongst others, of credit risk.
20. As part of the peer review, the FSB requested jurisdictions to present action plans to ensure the implementation of the FSB principles. The EU Action Plan to reduce reliance on CRA ratings was addressed in an EC staff working paper⁸, which outlines the overall EU conceptual framework to reducing reliance on CRA ratings. The EU conceptual framework provides an overview and summarizes all the existing and on-going policy actions taken on the basis of EU Regulations, Directives and implementing legislation and binding technical standards. It also includes guidelines adopted by the ESAs. Specific actions undertaken at national level are referred to in the EU FSB Members action plans.

⁶ [Roadmap for reducing reliance on CRA ratings: FSB report to G20 Finance Ministers and Central Bank Governors.](#)

⁷ [Thematic Review of the FSB Principles for Reducing Reliance on CRA Ratings.](#)

⁸ [EU Action Plan to reduce reliance on Credit Rating Agency \(CRA\) Ratings.](#)

II.II. IOSCO Committee 5 on Investment Management

21. On 3 June 2014, IOSCO published a consultation report on Good Practices on Reducing Reliance on CRAs⁹ prepared by its Committee on Investment Management ('Committee 5'). The report is aimed at gathering the views and practices of investment managers, institutional investors and other interested parties, with a view to developing a set of good practices on reducing over-reliance on external credit ratings in the asset management space.
22. While noting that most jurisdictions have removed the hard wired references to ratings from laws and regulations, the report recognizes that CRAs continue to play a prominent role in today's global financial markets. In particular, the report indicates there is no predominant way that investment managers use external credit ratings. According to the results of several mapping exercises conducted among IOSCO member jurisdictions over 2011-2012, investment managers predominantly use the services of CRAs:
- To form an opinion on the creditworthiness of a particular issuer to guide asset selection in the construction and optimization of an investment portfolio.
 - To guide the selection of eligible collateral received or posted from/to different counterparties.
 - To assess a counterparty's overall financial health and ability to uphold its obligations vis-à-vis one or more funds, as well as to determine the credit quality of certain guarantors or of sponsors that may provide support to certain pooled investment vehicles (e.g. money market funds or structured finance vehicles).
23. The use of external ratings is also driven by investors who often refer to external credit ratings before buying shares of a fund, or when guiding investment managers on the basis of a tailored investment mandate.
24. Taking account of these different uses, IOSCO's Consultation Report suggests ten possible good practices to reduce over-reliance on external credit ratings in the asset management space. In particular, the Consultation Report stresses the importance for asset managers to have the appropriate expertise and processes in place to be able to assess the credit quality of a financial instrument or counterparty. In performing such an assessment, asset managers may choose to use external credit ratings, however these should only be used as one element among others of the internal credit assessment process. In this regard, the Consultation

⁹ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD442.pdf>

Report insists on the importance for asset managers to disclose their alternatives to ratings and where appropriate the use of external ratings to complement their internal assessment.

25. While acknowledging that external credit ratings continue to constitute a “common language” used by investors and managers when defining the investment universe but also more specifically when designing investment guidelines for discretionary portfolio mandates, the Consultation Report recommends putting in place an appropriate framework for the use of external credit ratings: e.g. defining sound procedures in case of downgrades, encouraging managers to deviate from the CRA views based on their own assessment, ensuring a sufficient understanding of the methodologies and their parameters, etc.
26. Through this consultation, IOSCO’s Committee on Investment Management aims at reaching out to all relevant stakeholders to improve its understanding of market practices and, if possible, draw good practices from them. The consultation will also help to determine the extent to which practices may vary depending on factors such as asset class, size of the manager, types of instruments or issuers etc., while identifying potential limitations to the manager’s ability to reduce further reliance (e.g. requirements stemming from investor’s own regulation) as well as clarifying investment managers’ processes in case of external rating changes. Finally, the report raises the issue of rating of investment funds and seeks to hear from the industry on whether this practice should be seen as a source of concerns. IOSCO aims at publishing a final report by year-end 2014.

II.III. Basel Committee on Banking Supervision – Revision of the Securitisation Framework¹⁰

27. The Basel Committee on Banking Supervision is in the process of reviewing the Basel securitisation framework. The revision comprises a detailed set of proposals, including draft standards text, for a comprehensive revision of the treatment of securitisation within the risk-based capital framework. This initiative forms part of the Basel Committee's broader agenda to reform regulatory standards for banks in response to lessons learned from the global financial crisis.
28. For the purpose of the review, the BCBS has conducted two public consultations and will take into account the results of the related quantitative impact study in the final revision of the securitisation framework which remains to be published. The BCBS will also take into account the objective to strike an appropriate balance between risk sensitivity, simplicity and comparability.
29. The BCBS has proposed a simple hierarchical framework similar to that used for credit risk:

¹⁰ <http://www.bis.org/publ/bcbs269.pdf>

- Where banks have the capacity and supervisory approval to do so, they may use an internal ratings-based approach to determine the capital requirement based on the risk of the underlying pool of exposures.
- If the internal ratings-based approach cannot be used for a particular securitisation exposure, an approach based on external ratings may be used if permitted within that particular jurisdiction. Unlike the existing approach, however, capital requirements do not need to be based on external ratings even if they are available.
- Finally, if neither of these approaches can be used, a standardised approach would be applied.

II.IV. US Securities and Exchange Commission

30. On 8 January 2014 the SEC adopted its final rule concerning the removal from its Rule 15c3-1 of certain references to credit ratings under the Securities Exchange Act of 1934¹¹, following a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act which requires each Federal agency, including the SEC, to review any regulation issued by such agency that requires the use of an assessment of the creditworthiness of a security remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations.
31. The SEC amended its Rule 15c3-1 to remove references to NRSRO credit ratings from the provisions establishing lower haircuts for commercial paper, nonconvertible debt, and preferred debt.
32. For the purposes of the new version of the rule, a broker-dealer may consider a number of factors:
- Credit spreads (the spread between a security's yield and the yield on Treasury or other securities or the spreads of credit default swaps that reference the security or money market instrument, or MMI).
 - Securities-related research (whether providers of research believe that the issuer of the security or MMI will be able to meet its financial commitments, generally or specifically).
 - Internal or external credit risk assessments (developed internally by the broker-dealer or externally by a CRA).

¹¹ <http://www.sec.gov/rules/final/2013/34-71194.pdf>

- Default statistics (whether providers of credit information express a view that specific securities or MMI – or their issuers – have a probability of default consistent with other securities of MMI that have only a minimal amount of credit risk).
 - Inclusion in an index (whether a security, a MMI, or their issuers, is included as a component of a recognised index of instruments that have only a minimal amount of credit risk).
 - Enhancement and priorities (the extent to which a security or MMI is covered by credit enhancements, such as over-collateralisation and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions).
 - Price, yield and/or volume (whether the price and yield of a security or MMI or a CDS that references the security or MMI are consistent with other securities or MMI that the broker-dealer has determined have only a minimal amount of credit risk and whether the price resulted from active trading).
 - Asset-class specific factors (e.g. in the case of SFI, the quality of underlying assets).
33. The SEC specifies that such factors are not to be considered exhaustive or mutually exclusive. Additional factors might be relevant to assess whether a security or a money market instrument has only a minimal amount of credit risk. Moreover, certain factors, such as credit spreads, may not be applicable for bonds that are thinly traded. Each broker-dealer should analyse its unique situation when designing its policies and procedures.
34. Alternatively, the rule provides that the broker-dealer must apply a higher deduction if the firm determines that the security has more than a minimal amount of credit risk or the firm opts not to have policies and procedures to assess the creditworthiness of the class of security or money market instrument.
35. Moreover, the rule states that if the security does not trade in a ready market, the broker-dealer must apply a 100% haircut irrespective of the firm's credit risk deterioration.
36. The SEC acknowledges that there is a potential conflict of interest inherent in a requirement that relies to some extent on the subjective judgment of the broker-dealer. However, the rule also provides that policies and procedures that are reasonably designed should result in assessments of creditworthiness that typically are consistent with market data.

II.V. AFM Report on the Use of Credit Ratings

37. During the second half of 2013 and the first quarter of 2014, the AFM conducted a study on the use of credit ratings in the Netherlands by buy and sell side players, financial infrastructures and governmental institutions¹². The objective of the report was to gain some insight into the use of credit ratings in the Dutch market.
38. The report's findings were based on a focused literature study and interviews with relevant parties in the Dutch market. In addition to the interviews, some relevant questions were incorporated in the bi-annual self-assessments issued by the AFM to investment firms and collective investment schemes.
39. The conclusion of this exploratory study is that the use of credit ratings is still widespread but is seldom the only source for investment decision making.
40. The study further identified that in contracts between an investor and an asset manager, credit ratings are used to determine the bandwidth for investments. Following interviews with several asset managers some mitigating controls were mentioned that should prevent the cliff effect of mandatory sales, for example grace periods or replacement of investments into another fund can avoid massive sales of downgraded instruments.
41. Another use of ratings was found to be in the selection process for eligible counterparties. Where a change in credit rating occurs, it can lead to a shift of eligible counterparties, especially in the inter-banking market. The use of a credit rating limit for eligible counterparties occurs mostly in the internal policies of the market participants.
42. On average, the study found that smaller market participants rely on a higher degree on credit ratings. Larger institutions have more possibilities to make their own model for decision making, but also have stricter internal procedures and policies that require independent, quantitative limits as well. The models used by banks, CCPs and other financial institutions in the Netherlands show that credit ratings still play a role, but not a decisive one.

¹² [Exploratory study on the use of credit ratings in the Netherlands.](#)

III. Summary of Responses to ESA Questionnaire on the Use of Credit Ratings

43. This section summarises responses received from SCAs to the ESAs' questionnaire on the use of credit ratings by financial intermediaries under their supervision. Responses are organised by type of intermediary and then categorised along the lines of the various uses of credit ratings by intermediary, specific actions taken by SCAs to address contractual reliance, challenges encountered in reducing contractual reliance and finally encountered potential alternatives to credit ratings. Where provided by respondents, references to ratings in relevant regulations and guidelines are also highlighted.

III.I. Credit Institutions¹³

44. Ratings are currently considered by credit institutions to be an important benchmark factor and an easy way of communicating transparently to external investors, analysts or media the level of risk associated with debt and funding costs. External ratings are still considered a primary tool to display credit quality.

45. While SCAs have taken actions in order to identify and reduce the reliance on external ratings this has taken place in a relatively un-harmonised way. The next sections summarise the areas that are identified as the most prone to a sole or mechanistic contractual reliance on external ratings, the potential sources of such reliance (including the references to external ratings in the European regulatory framework), the actions taken to reduce such reliance and the challenges identified in this process.

Use of external ratings

46. Contractual use of external ratings by credit institutions can be identified in many of the main activities of credit institutions for example lending decisions, investment decisions, portfolio management, investment advice, collateral eligibility criteria, interbank or central bank refinancing operations and capital markets financing.

47. In particular, with respect to lending decisions, banks may include a review of external credit ratings in their credit approval process and may set thresholds below which they will not lend (i.e. the bank cannot lend to a counterparty with a credit rating lower than "A-"). In their investment decisions and advice activities, contractual references to credit ratings mainly occur in relation to portfolio management and investment advice. For example, the investment mandate may include specific constraints related to the creditworthiness of the entities or the financial instruments that can be advised or invested.

¹³ As referred to in Article 3(1) (pa) of the CRA Regulation.

48. As for the collateral assessment, ratings might be a criterion for eligibility for assets pledged as collateral, when banks enter interbank or refinancing operations for short-term funding purposes. In general, when different counterparties pledge assets as collateral, haircuts might be also calibrated according to the external credit quality assessments.
49. It is worth making a distinction between the use of external ratings for regulatory purposes and their contractual use. The contractual use of external ratings can be harder to establish.
50. In certain instances external ratings may also have two distinct roles. On the one hand they determine the eligibility of collateral, on the other hand the level of collateral to be posted might depend on the rating of the institution itself.
51. Special consideration should be devoted to products designed to reach a certain external rating. For a credit institution that issues debt instruments such as covered bonds programmes or more complex instruments such as asset backed securities, it is necessary to obtain and disclose an external credit rating to access the market and to match the investors' risk appetite.

Actions taken and harmonisation

52. Although certain SCAs have started or implemented specific actions following the CRA 3 obligations, in other jurisdictions no specific actions have been taken in their jurisdiction for the sole purpose of investigating or assessing the contractual use of external ratings by the supervised credit institutions.
53. That does not mean the reliance on external ratings has been neglected, as some SCAs highlight that ongoing supervision of regulatory initiatives can act as a proper tool to address this aspect. For example some SCAs conduct regular on-site inspections and assess the implementation of the institution's risk management and, among other aspects, these inspections include the assessment of the reliance on external ratings and the consideration of further sources of information within the risk management.
54. Some jurisdictions have regulations or guidelines specifying that whereas credit institutions may incorporate external ratings in their investment decisions, it is not permitted to take a rating as the sole basis for their decisions. More generally, SCAs that have identified reference to external ratings in their entities' investment decisions have agreed on the fact that this procedure be complemented with other equally important mechanisms of credit risk evaluation. The reduction of contractual reference to credit ratings has already been implemented in some national legislations (via laws, decrees and regulations) as well as in the on and off-site supervisory guidelines. It should be stressed that such approach, however, is not yet harmonised across the Union.

Challenges in promoting alternatives

55. National supervisors are generally empowered to issue regulations or guidelines and have the appropriate tools to allow them to mitigate against any specific risk that may arise through over-reliance on credit ratings. However SCAs have also identified challenges in finding alternatives measure of risk able to replace external ratings.
56. There was a high degree of correlation among respondents in this regard with a large number highlighting similar issues. Challenges preventing SCAs from encouraging this mitigation of contractual references to credit ratings include the lack of transparency of other measures, lack of credible alternatives to credit ratings, specific reference in relevant legislations and the respective size and complexity of some credit institutions.

Alternatives to external ratings

57. As mentioned above, large credit institutions use internal models to produce their own estimations of credit risk, i.e. internal ratings-based approaches where they use alternative tools and do not rely only on external ratings for the calculation of their regulatory capital. Although SCAs indicated that this is the main candidate as an alternative to external ratings, the use of the standardized approach did not appear to be discouraged.
58. There are a number of reasons why pushing institutions towards an internal rating-based approach might be inappropriate. The CRR¹⁴ recommends that the institutions should be encouraged to move towards the more risk-sensitive approaches as long these reflect the “nature, scale, and complexity” of the individual institutions' processes¹⁵.
59. In any case the scope of the internal rating-based approaches is not universal. Internal ratings are currently not covering rated securitisation positions, and find little application to the trading book's positions and moreover the eligibility of collateral associated to bespoke derivatives (i.e., bilateral contract and transactions) is usually based on external ratings or not based on ratings at all. Some SCAs also highlighted that for small banks, even focusing only on the lending process, it is rather inefficient and costly to build up an internal risk-based model. However, with regard to securitisations, the Basel Committee is currently review-

¹⁴ [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.](#)

¹⁵ See Recital 42 of the CRR.

ing its securitisation framework¹⁶ which will enable an internal rating based approach for securitisation positions.

60. Concerning the contractual references, internal ratings have a limited application. This is because two counterparties will hardly agree in a contract that depends on the credit quality assessment of one of the two parties and they might prefer to have an independent opinion expressed by a third party, i.e. an external rating provided by an ECAI.

References in regulations and guidelines

61. The actions the SCAs may take, the available alternatives and their limitations are discussed in the previous section. The role that external ratings play in the ESAs' guidelines and recommendations is addressed in the first ESAs' report on over-reliance on external ratings¹⁷. This section summarises the main areas where references to external rating are used in the European banking regulation.
62. Although these regulations do not rely in a mechanistic way on external ratings, it is possible they may be misinterpreted by some market participants and result in practices that can be seen as sole or mechanistic reliance.
63. The use of the standardised approach does not appear to be discouraged by some SCAs as long as credit ratings are provided by credit rating agencies with a rigorous set of standards and it is proportional to the size and complexity of the institutions. Certain banking systems can be characterized by a large number of small credit institutions that use the standardized approach. In such jurisdictions, only a small number of corporate debt issuers have a credit rating or there is a low need of capital markets financing. Therefore, in some of those jurisdictions, the use of credit ratings among supervised entities might be marginal.
64. In accordance with the CRR, external ratings are used for determining capital requirements through direct or indirect reference to the rule on own fund requirements in the banking book. References to external credit ratings are easily identifiable in the following areas.
65. **Credit risk:** under the standardized approach, credit quality may be determined by reference to the credit assessments of ECAIs or the credit assessments of export credit agencies in particular concerning assignment of risk weights to exposures to central governments and central banks, regional governments and lo-

¹⁶ <http://www.bis.org/publ/bcbs269.pdf>

¹⁷ [Final report on mechanistic references to credit ratings in the ESAs' Guidelines and Recommendations](#) issued by EBA, EIOPA and ESMA on 6 February 2014.

cal authorities, public sector entities, institutions, corporate, covered bonds, exposures in the form of units or shares in CIUs, exposures as credit protection for n-th default baskets, a securitisation or re-securitisation position¹⁸. For the credit risk mitigation techniques¹⁹, i.e. the collateral framework, the credit quality of the protection provider may be determined by references to the credit assessments of ECAIs. Also under the internal rating-based approach²⁰ securitisation and re-securitisation position have a credit quality determined by reference to the credit assessments of ECAIs.

66. **Counterparty credit risk:** under the standardised method²¹, interest rate risk positions to hedging sets may refer to external ratings (although of very limited relevance in practice).
67. **Market risk:** under the standardised approach for specific risk, references to external rating play an important role in the own funds requirement for debt instruments²² and the standardised approach for own funds requirement for securitisation instruments²³. Although less material in practice, references to ratings are also present in the allowance for hedges by first and nth-to default credit derivatives²⁴. The scope and the parameters in the internal model approach to measure the incremental default and migration rely on external ratings migration²⁵.
68. **Large exposures:** Credit quality of the protection provider may be determined by references to the credit assessments of ECAIs²⁶.
69. The ESAs also introduced references to external ratings in additional reports and consultation papers which may be translated in regulation in the near future. For example, the EBA report²⁷ on HQLAs and the ESAs consultation paper on margin requirements for non-centrally cleared OTC derivatives²⁸.

¹⁸ Articles 114, 115, 116, 119-121, 122, 129, 132, 134 (6), 251 of the CRR.

¹⁹ Article 192 ff. of the CRR

²⁰ Article 261 of the CRR.

²¹ Article 281(2) of the CRR.

²² Article 336(1) of the CRR.

²³ Article 337 (1) of the CRR.

²⁴ Article 347 (1) of the CRR.

²⁵ Article 374 (1) of the CRR

²⁶ Article 401 (1) of the CRR

²⁷ [Report on appropriate uniform definitions of extremely high quality liquid assets \(extremely HQLA\) and high quality liquid assets \(HQLA\) and on operational requirements for liquid assets](#) under Article 509(3) and (5) CRR.

²⁸ [Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP](#) (JC/CP/2014/03).

III.II. Insurance/Reinsurance Undertakings/ IORPs²⁹

Use of external ratings

70. With regards to Insurance/Reinsurance undertakings a study of responses revealed that some of the main uses of external ratings concern the following areas:

- Estimating market risk.
- Estimating counterparty risk.
- Risk-mitigation techniques.

71. It is important to note that the use of credit ratings does not form part of the current Solvency I Regulations. However, Solvency II, which will come into force on 1 January 2016 for insurance and reinsurance entities, will require that undertakings “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 adjustment.” An additional requirement to produce own internal credit assessments is imposed on investments that are part of larger and more complex exposures of an undertaking.

Actions taken and harmonisation

72. Most respondent SCAs have already taken, or considered some form of, supervisory actions to encourage reduction of contractual reference to credit ratings. Supervisory approaches by SCAs can be broadly categorized into four categories:

- Adjustment of national legislation towards the new risk-based supervisory regime Solvency II³⁰.
- Removal of all references to ratings in national legislation.
- Use of on-going supervision for monitoring the use of ratings.
- No specific actions.

73. In the first category some SCAs consider that the transition towards the new risk-based supervisory regime Solvency II can be seen as a supervisory action to encourage reduction of contractual reference to credit

²⁹As referred to in Article 3(1),(pc),(pe) of the CRA Regulation.

³⁰[Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.](#)

ratings. Solvency II regime as it stands now will contain requirements for undertakings to reduce reliance on ratings.

74. In the second category one respondent SCA has removed all references to ratings from its pension legislation, however not yet from its insurance legislation.
75. In the third category there are a number of SCAs that use their on-going supervision and dialogue with intermediaries to both give guidance and (if necessary) take supervisory measures to encourage reduction of contractual references to credit ratings.
76. The fourth category consists of jurisdictions where very few entities with ratings exist. These SCAs say that their financial markets are typical of the somewhat marginal use of credit ratings, as only a limited number of the entities have a credit rating. Taking into account this situation, they suppose no specific actions to encourage reduction are necessary, because supervised entities are using contractual references to credit ratings proportionately.
77. On the other side some member states claim that regarding the insurance and reinsurance sector under the Solvency I framework, no specific action has been taken to encourage reduction of contractual reference to credit ratings, as Solvency I regulation does not mechanistically rely on credit ratings. The credit ratings of insurance and reinsurance undertakings portfolios are simply reported by undertakings when giving detailed investment information.

Challenges in promoting alternatives

78. SCAs highlighted that the obvious challenge when it comes to mitigating the use of ratings by market participants is that ratings are a preferred and transparent way of displaying risk by many stakeholders in the market especially for those without sufficient internal analytical resources. Examples given being trust funds and small institutions but also some supervisory authorities, and central banks. It was suggested that for these entities ratings are a transparent way of comparing and understanding the risk involved.
79. It was also highlighted that the nature and scale of the activities of IORPs should be taken into account with regards to the mitigation of reliance on ratings.
80. Finally, some respondents indicated that they felt it would be disproportionate at this transitional stage towards Solvency II to set a requirement for small and medium size companies to create an internal valuation procedure to replace references to external ratings.

Alternatives to external ratings

81. All responding SCAs but one highlighted the use by firms under their supervision of some tools for the credit quality assessment other than external credit ratings, examples provided being:
- Financial statements indicators – e.g. debt indicators, liquidity, activity, effectiveness, profitability and cash flow ratios, probability of default indicators.
 - Macroeconomic and microeconomic indicators – e.g. expected interest rates, exchange rate, and economic situation trends, GDP growth rate.
 - Market data – e.g. CDS quotations, market prices.
 - Internal credit risk models.
 - SWOT analysis, management and auditor quality, specialized web portals.
82. Some SCAs did not explicitly specify the nature of the alternative tools but instead indicated it was their expectation that large insurers and reinsurers already use their own tools for the credit quality assessment.
83. Other SCAs were however more specific. For example large insurers and reinsurers assess the creditworthiness of the largest investors or issuers. In reinsurance strategy, some may look for collateral as an alternative to a rating. Other undertakings have long term relationships with certain groups and therefore their counterparty risk appetite is dictated by such measures. In one big market a few large insurance and reinsurance undertakings using internal models for Solvency II capital requirement calculation, have been asked, in the framework of the control reports they have to produce regarding their preparatory work for Solvency II, to set out alternative ways of assessing credit risk, in order to be able to potentially rectify the externally allocated credit ratings.
84. In smaller markets with a low number of rated entities, financial intermediaries use a larger range of tools in credit risk measurement. Also, in smaller markets, local subsidiaries of large insurance groups may access to credit risk analysis and internal ratings conducted by central credit research teams typically located at the group's headquarters.

III.III. Investment Firms³¹

Use of external ratings

85. SCAs have highlighted that investment firms engage the use of credit ratings on a contractual basis in a wide variety of ways. For example, for the purposes of raising finance, investment firms may occasionally refer to external ratings in order to communicate the risks involved to investors. They may also be referred to where the credit rating of the institution with whom the investment firm is engaging could be a factor for investors.
86. It was noted by SCAs that the use of credit ratings by investment firms is less pronounced than it is among credit institutions.
87. Further responses indicate that to the extent investment firms engage in financial services similar to those of credit institutions, the areas of use of credit ratings between the two sets of intermediaries are broadly similar, for example, contingent credit or collateral management. The analysis and solutions described in section III.I for credit institutions can therefore also apply to investment firms with the same obviously applying in the opposite direction.
88. In addition, external credit ratings have been identified as playing an important role in providing a benchmark for approved counterparties in liquidity management operations. This is particularly the case for smaller investment firms that lack the resources to conduct internal credit assessments of individual counterparties.
89. External ratings also play an important part in the provision of investment advice by investment firms. This is primarily driven by clients who prefer the simplicity and transparency of external ratings for understanding and comparing the risk and reward of investment alternatives. Investment mandates provided by clients to asset managers may also make use of external ratings for similar reasons of comparability.
90. Investment firms may also use ratings in the prospectuses of structured products in order to illustrate the level of credit risk in the product offered. As already stated, SCAs have reported that this is driven by investor demand for transparency and ease of understanding and comparison of the risk/return between investment alternatives.

³¹ As referred to in Article 3 (1) (pb) of the CRA Regulation.

91. In addition, SCAs have highlighted that in respect of proprietary trading, the credit rating of counterparties can also be considered a factor as part of investment firm's risk management activities.

Actions taken and harmonisation

92. Only a small number of the SCAs that responded to the questionnaire have taken specific action to minimise contractual reliance on external ratings by investment firms.
93. One SCA has introduced requirements for financial intermediaries, including investment firms, to adopt and manage policies and procedures to identify and manage the risks related to their activities, procedures and systems.
94. Another SCA has introduced minimum requirements for risk management which required institutions to implement appropriate and effective risk management according to the individual size, complexity, business activities and risk situation of the firm. Under these minimum requirements reference to external credit ratings do not exempt institutions from their obligation to form their own judgements of the respective credit/counterparty risk or to incorporate their own findings into their credit assessments.

Challenges in promoting alternatives

95. With regards to promoting alternatives to external credit ratings perhaps the greatest challenge arises with respect to the nature, scale and complexity of investment firms. Smaller investment firms might face great difficulties in building up sufficient resources for performing internal credit risk assessments.
96. In addition, many clients of investment firms express a clear preference for third-party opinions like external credit ratings for reasons of clarity and transparency.
97. For these reasons it might be challenging for both small and medium sized investment firms to eliminate references to ratings.

Alternatives to external ratings

98. While it may be difficult to replace external credit ratings altogether, as an alternative some SCAs indicated that with regards to the provision of investment advice, some investment firms have developed in-house models that incorporate any available external credit ratings relating to the entity concerned.
99. Other SCAs have highlighted that some investment firms now operate internal creditworthiness assessment systems or tools which complement the use of external ratings in a similar manner to the above. These firms look at alternative benchmarks like credit spreads or other market signals as part of their assessments.
100. Some SCAs have indicated that while no specific action has yet been taken on their part to mitigate contractual reliance on external credit ratings they nevertheless continue to encourage an internal ratings-based approach and assess the use of contractual references by credit institutions and investment firms under their supervision.

References in regulations and guidelines

101. As is the case with credit institutions, a majority of respondents highlighted CRD IV and CRR as the legal basis for the reliance on credit ratings by investment firms. Similar to credit institutions this reliance may arise with respect to the calculation of credit risk within the standardised approach, where institutions use external ratings to assign risk weights to exposures in order to determine capital requirements, calculation of collateral haircuts and liquidity requirements.

III.IV. Management Companies, Investment Companies, Alternative Investment Fund Managers³²

Use of external ratings

102. Reference to credit ratings within the asset management industry is relatively common. For example, many asset managers use credit ratings as at least as one parameter when making their investment decisions. Other examples as to where the use of external ratings by this class of financial intermediary can arise as a factor are within investment mandates, the evaluation of financial instrument eligibility, calculation of haircuts in collateral operations (i.e. securities lending) or the evaluation of collateral in repo and reverse repo operations.

³² As referred to in Article 3(1)(pf),(pg),(ph) of the CRA Regulation.

103. Many of these references to external ratings are contractual in nature and can arise as clauses of asset managers' investment mandates. For instance, collective investment schemes' prospectus can include minimum thresholds of creditworthiness defined by reference to external ratings. Also with regards to the evaluation of financial instrument eligibility in Collective Investments Schemes (CIS), the credit rating at the time of a purchase operation is considered, and again at each re-evaluation date.

Actions taken and harmonisation

104. Only some SCAs have taken specific actions to identify and reduce the contractual reliance on external ratings in this area. In one of these jurisdictions, a combination of approaches has added some references to external ratings while also removing others. For example, legislation has been introduced stating that a CIS within this same jurisdiction may invest up to 35% of its assets in transferable securities or money market instruments issued by the same body if they are issued or guaranteed by a third country with a rating not less than that of the state at all times. At the same time other requirements state that the management company must conduct a comprehensive analysis of the issuance in order to reassure regarding its solvency.

105. In this same jurisdiction mutual funds that invest most of their assets in domestic government debt instruments are allowed to invest up to 30% of their total assets in fixed income, deposits in credit institutions and money market instruments different from domestic sovereign debt securities, as long as the issuers have a credit rating awarded by a CRA not lower than that of the state in question at the time of the investment decision. However, if the issuance loses the credit rating later, the CIS is allowed to maintain this investment as long as the management company determines, according to its internal credit assessment, that the instrument has enough creditworthiness.

106. In addition, requirements have been introduced specifying that a CIS in this same jurisdiction can enter into an OTC contract as long as the management company, after carrying out an internal assessment, concludes that the counterparty's creditworthiness is enough to meet its commitments.

107. Another SCA has additionally issued a circular on the minimum requirements for risk management of asset management companies, describing due diligence procedures to apply to all new investments and setting out where the structure of the products and inherent risks need to be analysed. This circular also requires internal risk assessment and monitoring of credit or counterparty risk, among others, and requires the management company to assess internally and monitor the quality of both issuers and counterparties. The company is also required to implement position limits in line with the assessment that are specific to the issuers and counterparties. In these internal assessments, external ratings can only be one factor among others.

Challenges in promoting alternatives

108.No specific challenges to encouraging mitigation of reliance on ratings have been identified by SCAs. However it has been outlined that in attempting to do so there was a difficulty with respect to a lack of credible alternatives and a lack of resources within some institutions to provide internal assessments.

109.It has also been highlighted by some SCAs that market stakeholders often express pushback on the proposal to reduce contractual reliance on credit ratings with regards to MMFs, for the reasons that these financial intermediaries cannot migrate away from using credit ratings in the manner sought by the CRA Regulation as investors in MMFs would find it extremely difficult to support internally the standard of credit analysis undertaken by CRAs.

Alternatives to external ratings

110.With regards to alternatives to credit ratings for creditworthiness assessments, as mentioned above, some management companies of funds are already required to internally assess credit quality as part of an appropriate risk management system. The nature and methodology of such depends strongly on the investment focus of the management company.

111.Within the EU, all investment funds (or their managers) fall under either the UCITS Directive or the AIFMD. Both directives place obligations on investment fund managers regarding the establishment of sound risk and liquidity management policies and procedures³³. These requirements are aimed at ensuring that the risk profile of the fund's investments are suitable to its redemptions policy and that the adopted mechanisms, procedures and techniques are proportional to the nature, dimension and complexity of the services and activities provided by the management company and their managed CIS, while also being consistent with their risk profile.

112.The UCITS Directive and AIFMD³⁴ also aim at ensuring that the risk management policy of a management company should predict and analyse the investment's contribution to the composition, liquidity, risk and income profiles of the CIS's portfolio before execution. These analyses should be based on reliable and updated information that is both qualitative and quantitative.

³³ See in particular Article 15 and 16 of the AIFMD, and Article 38-40 of Directive 2010/43/EU (the UCITS Level 2 Management Company Passport Directive)

³⁴ In the AIFMD context, see in particular Articles 38-42 of the AIFMD Level 2 Regulation. For UCITS, the Risk Management Principles adopted by CESR are also relevant (http://www.esma.europa.eu/system/files/09_178.pdf).

113. Moreover, as part of an alternative risk management policy the management company should execute, when appropriate, periodic back-tests, as well as periodic stress tests and scenario analyses related to the on-going risks occasioned by market conditions that could prejudice the collective investment scheme.

114. Furthermore, where an in-depth credit analysis based on an internal credit quality assessment of instruments and issuers does not take place, management companies will at least have to conduct a plausibility check of such external ratings by comparison with economic and business indicators and market data. In these situations, too, the credit quality assessment should include qualitative factors additional to quantitative factors.

III.V. Central Counterparties³⁵

Use of external ratings

115. SCAs have identified several uses of external ratings by CCPs.

116. As highlighted by a large number of SCAs, EMIR³⁶ and the related Regulatory Technical Standards (RTS)³⁷ introduced regulatory requirements for CCPs to ensure that they do not only rely on external ratings.

117. These RTS specifically require CCPs to employ a defined and objective methodology, which does not rely solely on external opinions in performing the assessment of the level of credit (and/or market) risk associated with:

- a. The type of assets accepted as collateral, including:
 - i. The credit risk of financial instruments' issuer (Annex 1, section 1 (a) of RTS).
 - ii. The market risk of the financial instruments (Annex 1, section 1 (b) of RTS).
 - iii. The determination of haircuts to apply to collateral (art.41.2 (a) of RTS).
 - iv. The determination of concentration limits ensuring sufficient collateral diversification (art. 42.3(b) of RTS)).

³⁵ As referred to in Article 3(1)(pi) of the CRA Regulation.

³⁶ [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.](#)

³⁷ [Commission Delegated Regulation \(EU\) No 153/2013 of 19 December 2012 supplementing Regulation \(EU\) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties.](#)

- b. The issuers of bank guarantees accepted as collateral (Annex 1, section 2 (a) of RTS).
- c. The debt instruments that can be considered highly liquid financial instruments (Annex II.1 (b) of RTS), for the purposes of eligibility of such instruments as collateral and as instruments in which CCP's financial resources can be invested.
- d. The authorised credit institutions and third country financial institutions that can be used as depositories for:
 - i. The deposit in custody of financial instruments posted as collateral, or default fund contributions or contributions to other resources (art 44.1.(b) and (c) of RTS).
 - ii. The deposit of cash (art 45.1.(b)(i) and (ii) of RTS).
 - iii. The deposit of gold (Annex 1, section 3 (c) and (d) of RTS).

118.CCPs authorised under EMIR have been deemed compliant with the above requirements.

119.Other areas where CCPs use external ratings include admission criteria for membership, where the credit rating of a prospective member may be used as an indicator within a comprehensive evaluation of the risk that a certain entity could represent to the central counterparty.

120.In addition, external credit ratings could be used for initial margins calibration for new clients, or positions where credit ratings are part of the Internal Credit Scoring tool of the CCP which are taken into account in the margining framework. Once again, the CCP does not rely solely on external credit ratings which are only one parameter in a set of independent parameters, themselves backed by qualitative internal expertise.

Actions taken and harmonisation

121.No SCAs have indicated whether specific legislative actions have been taken at national level to address contractual reliance on credit ratings by CCPs, however a large number highlight that as part of their supervisory assessment SCAs already assess CCPs compliance with EMIR which, as mentioned, includes the need for CCPs to ensure that they employ a defined and objective methodology that does not rely solely on external opinions.

Challenges in promoting alternatives

122. Prior to EMIR, the use of external credit ratings represented the easiest way to measure the level of risk of entities and allow a direct comparison between entities.
123. SCAs have highlighted that the main challenge for CCPs to use internal analyses when assessing the creditworthiness of clearing members or the eligibility of collateral has been developing their ability to perform such analyses.
124. The task of replacing references to external ratings with internal analyses has required significant effort on the part of CCPs for them to properly address all the indicators with the relevant level of risk. Specifically, CCPs must have suitable tools to manage and update the information and have a very deep knowledge of the subject of the analysis in order to include all the relevant evidence for obtaining a reliable output from such analysis. These constraints have likely prevented CCPs from relying entirely on internal methodologies.
125. On the other hand, it was also highlighted that the benefits of internal creditworthiness assessments allow CCPs to take into consideration specific features that the external credit ratings do not express, such as relations between its clearing members or the crosscutting relationships between entities that are at the same time clearing members and issuers or depositories of guarantees/collateral. Another respondent explained that as ratings are now only one parameter with respect to their CCP's assessment of collateral eligibility, a credit downgrade could not now of itself directly trigger significant changes in a CCP's internal evaluation.

Alternatives to external ratings

126. As already mentioned, CCPs are currently required by EMIR to employ defined and objective methodologies that do not rely solely on credit ratings for their creditworthiness assessments.
127. CCPs have therefore implemented such methodologies according to the requirements deriving from EMIR in order to include complementary internal mechanisms and analyses, e.g. when assessing quality of assets that could be accepted as collateral, or when assessing entities that can be depositories of the CCP's financial instruments or cash received as collateral.
128. Further to this, one SCA highlighted that while external credit ratings had been used in the past in relation to membership and eligibility assessments, in accordance with the requirements for CCPs under EMIR, their CCP has changed from rules which were strongly based on external credit ratings to an internal assessment. This assessment includes factors such as financial capacity, technical and operational capacity, legal, regula-

tory and supervisory background as well as external ratings to help measure the creditworthiness of clearing members.

IV. Conclusion

129. In accordance with the specifications outlined under “Responding to this Paper” the ESAs hereby welcome responses to the questions for both SCAs and financial intermediaries provided in Annex I.

Annex 1 - Questions

Questions for Sectoral Competent Authorities

Q1. Have specific supervisory actions already been considered by your SCA to encourage your supervised entities (if more than one type please specify) to reduce the contractual reference to credit ratings?

Q1 i) what are the main reasons for the firms you supervise to employ contractual references to credit ratings?

Q1 ii) In your particular sector, which alternatives could potentially replace or reduce the use of external credit ratings?

Q1 iii) Are there any measures in the contractual agreements of the entities that you supervise that limit or mitigate the risk of sole and mechanistic reliance on credit ratings?

Q2. Can you identify some of the main challenges preventing these entities from mitigating contractual references to credit ratings?

Q3. On the basis of your supervisory experience, do you think alternatives to credit ratings are appropriate and necessary?

Q4. What alternatives to credit ratings are these entities using to assess credit quality? What are their applications?

Q5. What are the specificities of your supervised entities that make it more difficult for them to use alternatives to credit ratings?

Q6. How could the reduction of contractual references to credit ratings by your supervised entities influence, in your opinion, the transmission of systemic risk?

Q7. Does the existence of funds/ETFs/Index-tracking UCITS and benchmarks whose composition depend on securities' ratings represent a concern? Is it necessary to mitigate contractual reliance on CRA ratings in this situation?

Q8. Does the existence of products designed to reach certain external ratings represent a concern?

Questions for Financial Intermediaries

Q9. To what extent do your business lines use external ratings? Please specify by activity.

Q9 i) What are the main reasons to use external ratings in contractual agreements?

Q9 ii) Are there elements in your contractual agreements that limit or mitigate the risk of sole and mechanistic reliance on external ratings?

Q10. What in your view are the main advantages or disadvantages of using external ratings?

Q11. Do you conduct any analysis of the underlying methodologies of the ratings you rely on? If so what in your view are the strengths and weaknesses of the methodology?

Q12. Can you provide examples of past experience where external credit ratings provided an inaccurate credit worthiness assessment? If so, what actions were taken in response to mitigate similar occurrences?

Q13. What internal risk analyses do you currently employ? What business lines are these employed in? To what extent do they utilise external ratings? What are the main advantages of these internal analyses?

Q14. Please specify what alternative references or benchmarks your internal risk analyses make use of.

Q15. Are these alternative measures point-in-time or through-the-cycle compared with external ratings?

Q16. In what areas is reducing reliance on external ratings necessary or at least desirable?

Q17. What in your view are the main challenges preventing you from reducing reliance on external ratings in your business?

Q18. How could the reduction of contractual references to credit ratings influence, in your opinion, the transmission of systemic risk?

Q19. Are there any additional points you would like to highlight with regards to contractual reliance on external ratings?