

EBA, EIOPA and ESMA

Joint Consultation Paper

On

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

(JC-CP-2013-02)

London, Frankfurt, Paris, 7 November 2013

Responding to this consultation paper

EBA, EIOPA and ESMA (the ESAs) invite comments on all matters of this consultation 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;
- respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternative the ESAs should consider.

Please send your comments by 5 December 2013 cob. You will find the link to consultation form on the respective public consultation websites of EBA, ESMA and EIOPA. Please note that comments submitted after the deadline will not be processed.

Publication of responses

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

Data protection

Information on data protection can be found at www.eba.europa.eu, www.esma.europa.eu and at www.eiopa.europa.eu under the heading 'Legal Notice'.

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Acronyms

EBA	European Banking Authority
ESMA	European Securities and Markets Authority
EIOPA	European Insurance and Occupational Pensions Authority
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
NCA	National Competent Authorities
SCA	Sectoral Competent Authorities
MMF	Money Market fund
MFI	Monetary Financial Institutions

I. Overview

Reasons for publication

1. New Art. 5b(1) of the CRA Regulation – as amended by the CRA3 Regulation - states that 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, EBA, EIOPA and ESMA shall review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations.
2. The scope of the new 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 the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and Committee of European Securities Regulators (CESR), and which are still in force.
3. In the founding regulations of EBA, EIOPA and ESMA, Article 76(4) states that the authorities shall be considered the legal successor of respectively CEBS, CEIOPS and CESR. Consequently these Guidelines, as requested by Article 5b(1), also take into account previous guidelines and recommendations issued by the Committees.
4. The objective of the present Consultation Paper is to submit for public consultation the view of the three ESAs with respect to the revision and removal of rating references as stated in Art. 5b(1). The paper is published in order to gather external views on prospective modifications of current guidelines, recommendations and technical standards that contain relevant references to ratings.

Contents

5. Art 5b(1) identifies “sole or mechanistic reliance” as a characteristic for inappropriate credit rating references. As the term is not defined in current regulation, Section II provides a definition for “sole or mechanistic reliance”. In Section III the concept of sole or mechanistic reliance is illustrated by examples of rating references. While Section IV lists provisions from EIOPA, EBA and ESMA guidelines and recommendations that contain rating references that should not be viewed as “sole or mechanistic”, Section V lists a set of provisions that according to the ESAs require revision. Annex I contains the list of the questions of the present consultation; Annex II provides an impact assessment about the scope of financial markets exposed to external ratings and discusses observable effects of sole or mechanistic reliance; Annex III lists the references to ratings contained in the Solvency II Directive; Annex IV pro-

vides a recapitulation of the draft guidelines and recommendations, waiting for the comments to the present consultation paper.

Next steps

6. EBA, EIOPA, and ESMA will consider the responses they receive to this consultation paper and expect to adopt a final report, which will contain the final guidelines. The final report will be adopted by the Joint Committee of the three ESAs by end 2013 and then ratified by the Board of Supervisors of the three ESAs.

II. Definitions

7. CRA Regulation: Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies amended by Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 and by Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013.
8. CRA3 Regulation: Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.
9. National Competent Authorities: Authorities as defined in the CRA Regulation, Art. 3(1)(p).
10. Sectoral Competent Authorities: Authorities as defined in the CRA Regulation, Art. 3(1)(r).

II.I. Definition of “sole or mechanistic reliance”

11. While Art. 5b(1) of the CRA Regulation provides that the three ESAs should not refer to credit ratings where such references have the potential to trigger “sole or mechanistic reliance” on credit ratings, the same Regulation does not include a formal definition of sole or mechanistic reliance nor explain its meaning in greater detail.
12. To have a clear and consistent understanding of “sole or mechanistic reliance”, EBA, EIOPA and ESMA have agreed to adopt the following definition:

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 solely based on credit ratings (or credit rating outlooks) without any additional discretion.
13. Such definition is based on the understanding reached by the EP, the Council, and the Commission during the negotiation of the CRA3 Regulation. However, such understanding has not previously been translated into a formal definition.

Q1. Do you agree with the definition of sole or mechanistic reliance on ratings provided in this document?

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

14. The present section provides examples aimed at clarifying the definition of “sole or mechanistic reliance”.

III.I. EBA

15. The EBA has issued guidelines on the mapping of credit assessments to Credit Quality Steps where the use of ECAIs external ratings in the Standardised Approach of the capital framework could appear to constitute sole or mechanistic reliance. Consequently, the use of external ratings to determine capital requirements, which will increase as a consequence of ratings changes that trigger a change in the credit quality steps fall within the definition of mechanistic reliance, if no mitigating factors, such as discretion to deviate, exists. Against this framework, the CRR introduce such mitigating tools. Section V.I below elaborates further on the use of external ratings and their mapping in the standardised approach and the provisions that mitigate the reliance on such references.

III.II. EIOPA

16. EIOPA has not identified any guidelines, in force or currently under development, to be used as an example of mechanistic reliance. Instead of proposing a hypothetical example, the following examples illustrate provisions of the current draft Implementing measures of Solvency II framework.

Use of ratings for Solvency Capital Requirement calculation for spread risk

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

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

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

Cliff effects and the BBB limits

21. The provisions on the final design of the classical matching adjustment are still to be decided in the Omnibus II negotiations. However for the purpose of this paper to illustrate an example we took the text in the Long-Term Guarantees (LTG) Assessment of EIOPA which includes a minimum credit quality (BBB and above), including a 33,3% limitation on the holdings of BBB investments. There is also a concern that a downgrade of a small portion of a portfolio can lead to a complete loss of the matching adjustment. In particular, the current minimum credit quality restrictions introduce a cliff-effect. Since matching portfolios are typically managed on a long-term basis, it is possible that assets which were originally of investment grade quality (BBB or above) can subsequently migrate.

III.III. ESMA

22. According to the guidelines on a Common Definition of European Money Market Funds (Ref. CESR/10-049, hereafter the Money Market Funds Guidelines), Short-Term Money Market Funds and Money Market Funds should only invest in high quality money market instruments. A money market instrument should not be considered to be of high quality by managers of Short-Term Money Market Funds and Money Market Funds unless it has been awarded one of the two highest available short-term credit ratings by each recognised credit rating agency that has rated the instrument.

IV. Guidelines and Recommendations currently in force which contain references to ratings which are NOT considered as sole or mechanistic

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

IV.I. EBA: List of Guidelines and Recommendations with reference to External Ratings

IV.I.1 CEBS Guidelines on Stress Testing (GL32), 26 August 2010

24. The EBA has reviewed the previously issued Guidelines and Recommendations for references to external ratings. The below list is the result of this review as regards guidelines and recommendations, that do not constitute a mechanistic reliance.

www.eba.europa.eu/documents/10180/16094/ST_Guidelines.pdf

Page 34, Annex 3, Paragraph 8.

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

Page 42, Annex 5, Paragraph 8.

“Three types of stress scenarios are expected to be applied: idiosyncratic, market-wide, and a combination of the two. The idiosyncratic stress might assume no rollover of unsecured wholesale funding and some outflows of retail deposits. In addition, a typical bank-specific scenario is, for example, a downgrading (for example, a 3 notches downgrade) of an institution’s debt instruments (including SPV issued CP) by external rating agencies. The market-wide stress might assume a decline in the liquidity value of some assets and deterioration in funding market conditions. In addition, market stress scenarios can involve market disruptions or changes in the macro-economic environment in which the institution is operating, or the downgrading of countries in which the institution is operating.”

IV.I.2 High level principles for risk management, 16 February 2010

www.eba.europa.eu/documents/10180/16094/HighLevelprinciplesonriskmanagement.pdf

Page 5, Paragraph 15.

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

return on equity and a narrow variance around that target rate of return. They may also question how a high target rate of return on equity can be consistent with maintaining a high credit rating throughout the business cycle.”

IV.I.3 Guidelines on operational risk mitigation techniques, 22 December 2009

www.eba.europa.eu/regulation-and-policy/operational-risk/guidelines-on-operational-risk-mitigation-techniques

Page 3, Paragraph 15.

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

Page 6, first bullet point.

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

IV.I.4 Compendium of Supplementary Guidelines on implementation issues of operational risk, 27 July 2010

www.eba.europa.eu/documents/10180/16094/Compendium_v2.pdf

Page 26, Section 3.1, Paragraph 12.

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

equivalent to credit quality step 3 or better 18, based on the long-term claims paying ability rating of the insurer”.

IV.I.5 Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised), 25 January 2006

www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-the-application-of-the-supervisory-review-process-under-pillar-2

Page 22, Section ICAAP 6, Paragraph b.

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

Page 22, Section ICAAP 9, Paragraph f.

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

IV.I.6 Revised Guidelines on the recognition of External Credit Assessment Institutions, 30 November 2010

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

Page 27-35, Part 3: “Mapping” (See entire chapter)

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

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

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

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

IV.I.8 EBA Guidelines on Internal Governance (GL 44), 27 September 2011

www.eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-internal-governance

Page 35, Section 5.

“External risk assessments (including external credit ratings or externally purchased risk models) can help provide a more comprehensive estimate of risk. Institutions should be aware of the scope of such assessments”.

IV.I.9 EBA Consultation Paper on Draft Regulatory Technical Standards for credit valuation adjustment risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios (EBA/CP/2012/09), 05 July 2013

www.eba.europa.eu/regulation-and-policy/credit-risk/draft-regulatory-technical-standards-in-relation-to-credit-valuation-adjustment-risk

Page 10, Recital (3)

“(3) An appropriate proxy spread should be estimated by the use of reliable market data and by applying the attributes of rating, industry and region of the single issuers. These attributes should be defined by considering minimum categories.”

Page 13, Chapter II, Article 3, Paragraph 1.

“1. The proxy spread for a given counterparty shall be deemed appropriate having regard to the rating, industry and region of the counterparty where all of the following conditions are satisfied: (a) the proxy spread has been determined by reflecting all of the attributes of rating, industry and region of the counterparty;[...]”.

Page 14, Chapter II, Article 3, Paragraph 2-4.

“2. A proxy spread satisfying the conditions in paragraph 1, but in relation to which additional attributes have been added to those of rating, industry and region shall be deemed appropriate if such attributes reflect the characteristics of positions in the institution’s CVA portfolio and take account of the availability of data satisfying the quality criteria set out in paragraph 5”.

“3. Notwithstanding paragraph 1, the estimation of the proxy spread for a subsidiary by the credit spread of the parent undertaking shall be deemed appropriate if at least two of the three attributes of industry, rating and region are, for the subsidiary and the parent undertaking, equivalent on the basis of the minimum categories defined in paragraph 1”.

“4. Notwithstanding paragraph 1, the estimation of the proxy spread for a regional government or local authority by the credit spread of the relevant sovereign issuer shall be deemed appropriate if the regional government or local authority and the relevant sovereign issuer are equivalent with respect to the attribute of rating”.

IV.II. EIOPA

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

IV.III. ESMA

IV.III.1 EMIR

27. Regulation No 648/2012 (EMIR)¹ does not contain any references to credit ratings. Implementing measures also did not include any references to credit ratings. In particular, Annex I and II of Commission Delegated Regulation (EU) No 153/2013, when referring to the conditions that financial instruments should meet to be accepted as collateral or for CCPs’ investment purposes, explicitly avoid overreliance on ratings as follows: “the CCP can demonstrate to the competent authority that the financial instruments have been issued by an issuer that has low credit risk based upon adequate internal assessment by the CCP. In performing such an assessment, the CCP shall employ a defined and objective methodology that shall not fully rely on external opinions and that takes into consideration the risk arising from the establishment of the issuer in a particular country”.
28. In the European legal and regulatory framework no reference is made to ratings in the margins, stress testing, back testing and sensitivity analysis requirements. However, it is not excluded that CCPs’ internal rules and procedures might rely on ratings when developing their models.

IV.III.2 Prospectus

29. There are currently no Guidelines adopted by ESMA that contain references to ratings.

V. Guidelines and Recommendations currently in force which contain references to ratings which are considered as sole or mechanistic and proposed action.

¹ 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

V.I. EBA: Standardised Approach and Mapping

30. The Standardised Approach (SA) was proposed in the Basel II capital adequacy accord for banking institutions in order to enable institutions to calculate capital requirements on credit risk in a simple manner. The SA was subsequently introduced in the Union via the CRD III legislation (Directives 2006/48/EC and 2006/49/EC²). The Basel III proposals, that are included in the recently approved CRD IV³ legislation (Regulation EU No. 575/2013 (CRR) and Directive 2013/36/EU) maintain the same approach, although it requests that the references to external ratings should be revisited.
31. In order to reduce as much as possible any mechanistic reliance, the CRD IV introduces a number of additional tools and requirements. Namely, under the CRD IV:
- a) Competent authorities are required to encourage institutions that are significant in terms of their size, internal organisation and the nature, scale and complexity of their activities to develop internal credit risk assessment capacity and to increase use of the internal ratings based approach for calculating own funds requirements for credit risk.
 - b) Competent authorities are also required to monitor, taking into account the nature, scale and complexity of an institution's activities, that the institution does not solely or mechanistically rely on credit ratings for assessing the credit quality of financial instruments and counterparties.
 - c) From 2014 onwards, EBA shall, in cooperation with EIOPA and ESMA, biannually publish a report about the extent legislation refers to external ratings, how to reduce such references and the degree of supervisory convergence.
 - d) Where credit risk is material, institutions should generally seek to implement internal ratings based approaches or internal models. However, less sophisticated institutions will keep relying on external ratings. External ratings can also be used for less material exposure classes or in situations where using internal approaches would be burdensome.
32. Under the Standardised Approach banks are required to use ratings from External Credit Assessment Institutions (ECAIs) to quantify the required capital for credit risk. In particular Articles 82 ff. of the Directives 2006/48/EC introduce the concept of Credit Quality Steps ('CQS'). These are explicitly related to ECAIs ratings via the 'mapping' that is further specified in the EBA *'Revised Guidelines on the recognition of External Credit Assessment Institutions'* (henceforth: the 'EBA-GL' or 'Guideline').⁴

² [Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions \(recast\) \(OJ L 177/1, 30.6.2006\)](#).

³ <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:176:SOM:EN:HTML>

⁴ www.eba.europa.eu/documents/10180/16094/Revised-Guidelines.pdf

The mapping is available in a separate file at the EBA website.⁵ An alternative mapping is provided for short term credit assessment.

33. The intent of the EBA Guidelines is to provide the basis for consistency across jurisdictions exclusively on the ECAI recognition for capital requirements related to the Standardised Approach and the Securitisation Ratings Based Approaches.
34. If neither the bank applying the Standardised Approach nor the supervisor has the possibility to explicitly intervene once that the mapping has been set, this framework could be considered as mechanistic reliance to external ratings. However, CRR Article 3 allows firms to apply measures stricter than those imposed by the Regulation, which could potentially include applying risk weights higher than those required by the Standardised Approach. Institutions may choose not to apply such higher risk weights, but they have the option of doing so under Article 3. Similarly, institutions have the option of determining any exposure under the standardised approach to be associated with particularly high risk under CRR Article 128 which would result in the application of a risk weight that is unconnected with credit ratings.
35. The CRD III (and CRD IV) operates with six CQS and as the ECAIs' credit assessment scales are often much more granular than that, the need for a mapping between the ECAI scales and the CQS is necessary. Consequently, the mapping links a range of ratings to a certain CQS, hence most external rating changes do not trigger a change on the CQS. However, when an external rating change triggers a change in the CQS, institutions applying the SA will have to use a different CQS to compute risk weighted assets. This change can be considered mechanistic as institutions cannot rely on an alternative credit assessment.
36. The mapping process takes into account a number of qualitative and quantitative factors. The quantitative factors, when available, consider especially historical default rates, whereas the qualitative factors include for instance differences in the definition of default, methodologies in calculating historical default rates, treatment of recently established ECAIs and pools of issuers covered.
37. Under CRD III, securitisation exposures are addressed in a similar manner to the mapping described above for other credit exposures. The main difference is that the number of CQS for securitisation position is less granular under the long term Standardised Approach as it only includes five CQS.
38. At the same time, the number of ECAIs actually providing ratings for securitisations is much smaller: only three ECAIs according to the available mapping and six according to the data available in the

⁵ www.eba.europa.eu/documents/10180/16151/4+Ausust+2006_Mapping.pdf

ESMA-CEREP database as of today. Under CRD III, the mapping of CQS to external rating for securitisation is addressed by the same Guideline.

39. Apart from some technical details, however, the treatment is not different from what done for exposures other than securitisations. Due to a lack of sufficiently objective internal methodologies most banks are expected to calculate their capital requirements referring to external ratings.
40. Despite all the recommendation described above, the framework of the standardised approach for credit risk can still be labelled, at least to a certain extent, as mechanistic reliance. That issue, however, is not generated at the level of the Guideline but it is intrinsic in the Basel framework and in the European implementation. Therefore, even if there is overreliance, this cannot be corrected by any action of the ESAs, such as amending or repealing the Guidelines, both for policy reasons (there is no available or agreed alternative), as well as for legal reasons (in the EU the Guidelines/recommendations or delegated legislation and implementing measures cannot amend the CRR).
41. Furthermore, CRR introduces a mandate for the ESAs⁶ to draft Implementing Technical Standards (ITS) specifying the mapping of the ECAIs to credit quality steps. A similar mandate for a separate ITS requires EBA to produce a mapping for securitisation.⁷ It should also be noted that the ITS will automatically repeal the Guidelines. Hence, amending or repealing the Guideline at this stage would have a very limited effect. To the contrary, repealing the Guidelines at this stage, without amendment of the basic legislation would lead to a situation of a legal void until the entry into force of the final ITS.
42. The ITS (due to be delivered to the EU Commission by July 2014) contains an analysis of historical performance of external ratings and takes into account, additional qualitative considerations for the new mapping. These and the fact that the mapping is expected to be reviewed periodically will further decreases the reliance on external ratings.
43. Based on all of the above considerations, the ESAs do not consider it appropriate to repeal or amend the Guidelines to remove the references to external ratings. Further work is however needed, especially in regard to the international workflows (most notably, the Basel Committee Task Force on the Standardised Approach) that aim to find alternatives for replacing the mapping to external ratings in the standardised approach and the mapping for securitisations exposures. Moreover, EBA, ESMA and EIOPA will consider the reliance in their work on the development of the ITS on the ECAI mapping required by Regulation (EU) No 575/2013.⁸

V.II. EIOPA

⁶ Regulation (EU) No 575/2013, Article 136(1).

⁷ Regulation (EU) No 575/2013, Article 270.

⁸ http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm

44. There are currently no Guidelines adopted by EIOPA that contain references to ratings.

V.III. ESMA: Revision of the ESMA guidelines on Money Market Funds

45. The purpose of this section is to set out a proposal for an amendment to the Money Market Funds guidelines⁹ with respect to the assessment of the credit quality of money market instruments by managers of Short-Term Money Market Funds and Money Market Funds.
46. It is proposed to modify the Money Market Funds Guidelines by amending paragraph 4 of Box 2 and paragraph 2 of Box 3 of the guidelines as set out below.
47. Paragraph 4 of Box 2 would be replaced by the following:

“4. For the purposes of point 3a), ensure that the management company performs its own documented assessment of the credit quality of money market instruments that allows it to consider a money market instrument as high quality. Such an assessment should have regard to the credit rating(s) provided by one or more credit rating agencies registered and supervised by ESMA. While there should be no mechanistic reliance on such external ratings, any downgrade below the two highest short-term credit ratings used by such an agency should lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of high quality.”

48. Paragraph 2 of Box 3 would be replaced by the following:

“[...]

In addition, a Money Market Fund:

2. May, as an exception to the requirement of point 4 of Box 2, hold sovereign issuance of a lower internally-assigned credit quality based on the MMF manager’s own documented assessment of credit quality. Such an assessment should have regard to the credit rating(s) provided by one or more credit rating agencies registered and supervised by ESMA. While there should not be mechanistic reliance on such external ratings, any downgrade below investment grade by such an agency should lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of appropriate quality. ‘Sovereign issuance’ should be understood as money market instruments issued or guaranteed by a central, regional or local authority or central bank of a Member State, the European Central Bank, the European Union or the European Investment Bank.”

49. The merit of this approach is that it is more principles-based and avoids mechanistic reliance on credit ratings by removing the ‘floor’ set in the previous guidelines for eligibility of money market instru-

⁹ http://www.esma.europa.eu/system/files/10_049.pdf

ments for Short-Term Money Market Funds (i.e. the reference to the top two credit ratings), while retaining an obligation on the manager to have some regard to external ratings. In particular:

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

Q2. Do you agree with the proposed action as regard EBA and ESMA Guidelines and Recommendations?

Q3. In particular, do you agree with the proposed revisions of the ESMA Money Market Funds Guidelines? If not, please suggest an alternative.

Annex I: List of consultation questions

- Q1. Do you agree with the definition of sole or mechanistic reliance on ratings provided in this document?
- Q2. Do you agree with the proposed action as regard EBA and ESMA Guidelines and Recommendations?
- Q3. In particular, do you agree with the proposed revisions of the ESMA Money Market Funds Guidelines? If not, please suggest an alternative.

Annex II: Draft Impact Assessment on reducing sole or mechanistic reliance on credit ratings

Introduction

This impact assessment provides a first version of the full Cost-Benefit Analysis (CBA) which will be published with the final document, and aims at informing the draft Joint-Committee Guidelines on reducing mechanistic reliance on credit ratings.

Among the observable effects of mechanistic reliance, the European Commission indicates that it would be desirable to reduce so-called “cliff effects”, which it defines¹⁰ as “sudden actions that are triggered by a rating downgrade under a specific threshold, where downgrading a single security can have a disproportionate cascading effect”. Fire sales of assets may for example impact the downgraded issuer “because its access to the money market funding may suddenly close, which may affect its viability”.¹¹

The acknowledgement of cliff effects builds on prior work from the Financial Stability Board and the IMF, with the latter highlighting¹² the “second-round liquidity effect” that a rating action may trigger, whereby the credit quality of a rated entity can be affected by the higher cost of capital resulting from a rating action. The higher cost of capital following downgrades is also referred to in the academic literature¹³: as “a rating downgrade may lead to higher cost of capital for the borrowing firm because it induces a deterioration in investors’ perceptions about the credit quality of the borrowing firm, because of regulations that restrict investors’ holdings of lower rated bonds, or because of rating triggers in financial contracts”.

In October 2010, the FSB endorsed principles to reduce public authorities’ and financial institutions’ reliance on credit rating agency ratings.¹⁴ The goal of the principles is to end mechanistic reliance by banks, institutional investors and other market participants. To accelerate the process the FSB published in November 2012 a roadmap with timelines to accelerate implementation of the FSB Principles. The roadmap suggests a two-way approach: (1) reducing mechanistic reliance in standards, laws and regulations; and (2) encouraging financial institutions to strengthen and disclose their credit risk assessment processes. In order to support the agreed the FSB is undertaking thematic peer review, whose main objective is to assist national authorities in fulfilling their commitments under the roadmap.

¹⁰ EC Impact Assessment amending the “Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies” and “Proposal for a Directive amending Directive 2009/65/EC on coordination on law, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers” (http://ec.europa.eu/internal_market/securities/docs/agencies/SEC_2011_1354_en.pdf)

¹¹ EC Impact Assessment accompanying the document “Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds” (http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-impact-assessment_en.pdf)

¹² IMF Global Financial Stability Report, October 2010, Chapter 3: “*The uses and abuses of sovereign credit ratings*” (<http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/chap3.pdf>)

¹³ G. Manso, UC Berkeley, “Feedback effects of credit ratings” (<http://faculty.haas.berkeley.edu/manso/ratings.pdf>)

¹⁴ http://www.financialstabilityboard.org/publications/r_101027.pdf

This preliminary impact assessment can be summarised in three main points. First, there could be potentially significant cliff effects from the EU money market funds industry, which has about EUR 1tn in assets under management, due to mechanistic reliance on external ratings in the current investment guidelines that could result in sudden and substantial changes in the universe of investable assets. Second, a large majority of banking institutions across EU Member States currently use the Standardised Approach to calculate their capital requirements for credit risk. Nonetheless, it is assessed that a very minor part of the exposures are connected to external ratings. Finally, in the insurance sector, the use of Credit Quality Steps as part of the Solvency Capital Requirement for the calculation of spread risk capital charge could eventually lead to additional mechanistic reliance on external ratings, therefore potentially liable to cliff effects.

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

1. CESR/ESMA Guidelines on a common definition of European money market funds

a. EU MMF industry

In the MMF guidelines¹⁵, money market funds are split between Short-term money market funds (STMMFs) and money market funds (MMFs). For the purpose of this impact assessment, the following two points are relevant in that distinction:

- STMMFs are required to invest in securities with a residual maturity of less than or equal to 397 days and have a portfolio-weighted average maturity that does not exceed 60 days, while MMFs do not face the same security maturity restriction as long as their portfolio-weighted average maturity does not exceed 6 months¹⁶;
- STMMFs are required to invest in securities that have been awarded “one of the two highest available short-term credit ratings by each recognised credit rating agency, or non-rated securities with credit quality equivalent to one of these two ratings, while MMFs may also invest in sovereign debt instruments rated at least investment grade¹⁷.

Although the EU MMF industry growth has declined in recent years, it remains nonetheless significant. In the Peer Review of MMF Guidelines¹⁸ conducted last year, ESMA has gathered information from National Competent Authorities on the number of MMFs in the EU and MMF Assets under Management (Table

¹⁵ CESR/ESMA Guidelines on a common definition of European money market funds (CESR/10-049) (http://www.esma.europa.eu/system/files/10_049.pdf)

¹⁶ Box 2 points 5 and 7, and Box 3 point 5 of the MMF guidelines.

¹⁷ Box 2 point 4 and Box 3 points 1 and 2 of the MMF guidelines.

¹⁸ ESMA Peer Review – Money Market Funds (http://www.esma.europa.eu/system/files/2013-476_-_peer_review_-_money_market_fund_guidelines.pdf)

T.01). According to this data, EU MMF assets amounted to EUR 1,039bn in 2012, including EUR 779.9bn for STMMFs only, and the number of funds totalled 1,242.

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

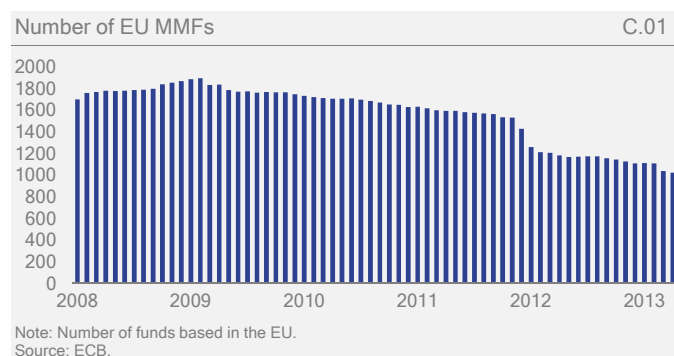
Note: Data and ECB exchange rates (for funds based outside the EA) as of 21 September 2012, which was the questionnaire deadline. Countries with no data were left out (EE, LI). STMMFs and MMFs listed based on self-declaration by funds.

Source: National Competent Authorities, ECB, ESMA.

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

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

Based on ECB data, the number of EU MMFs has declined nearly 50% from a high of 1,896 in February 2009 to 1,012 as of May 2013. According to the ESRB, part of this decline “occurred in the form of a consolidation of the sector following the implementation of the CESR/ESMA guidelines mentioned in Section I.2.”¹⁹



b. EA MMF assets

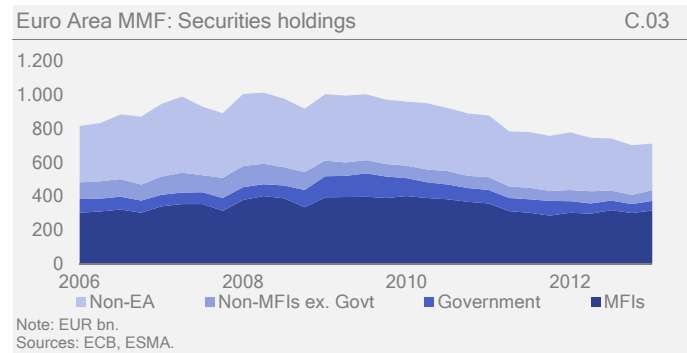
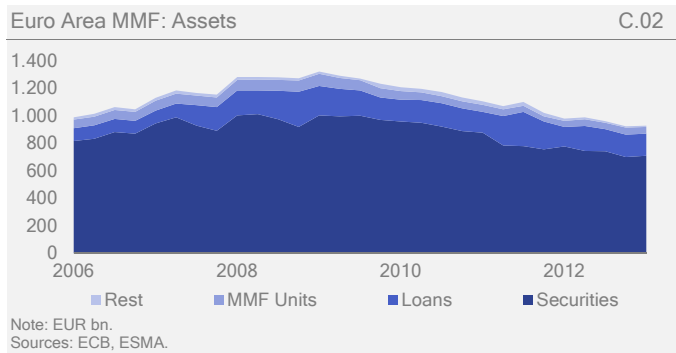
The ECB dataset also includes useful details on the assets of MMFs based in Euro-area (EA) countries, which amounted to 98.3% of total EU MMF assets (based on the data gathered by ESMA in its Peer Review of MMF Guidelines). EA MMF assets comprise a significant amount of debt securities (EUR 741.6bn as of 3Q12, or 77.2% of total assets), followed by loans (EUR 161.6bn, 16.8% of assets) and shares of other MMFs (EUR 47.5bn, 4.9% of assets). The shares of these respective assets in MMF balance sheets have remained broadly constant over time, as illustrated in C.02.

The securities held by EA MMFs were largely issued by other EA monetary financial institutions MFIs (EUR 317bn, 42.7% of all securities held by MMFs), and to a smaller extent by EA governments (EUR 56.7bn, 7.6% of the total) and non-MFIs excluding governments (EUR 58.4bn, 7.9% of the total). The share of EA government securities has decreased over time, from 14% in 1Q09 to

¹⁹ Annex to the ESRB Recommendation on money market funds

(http://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_1_annex.en.pdf?693f2e8ca5f8e87fa7ad424aca81fa52)

8% in 3Q12 (Chart C.03). Holdings of securities issued by non-EA entities—for which the data is not as granular—amounted to an aggregate EUR 309.4bn.



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

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

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

c. Investable universe and cliff effects

As required in the CESR Guidelines, in order to ensure a high quality portfolio, EU MMFs can only invest in specific assets (see Box). As a case study, this IA focuses on the investable universe of EU MMF in relation to EU sovereign debt securities. The case of sovereign downgrades is of particular interest as these have significant spill-over effects, as highlighted in the economic literature²⁰.

Methodology for investable universe quantification

The investable universe of EU MMF is defined in the CESR Guidelines. The Guidelines

²⁰ Rabah Arzeki, Bertrand Candelon and Amandou N.R.Sy, IMF Working Paper, “Sovereign Rating News and Financial Markets Spill-overs: Evidence from the European Debt Crisis”, March 2011, WP/11/68.

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

In order to estimate the MMF investable universe, the first step was to collect the short-term ratings of each Member State as of the end of 2012 from the three major CRAs (T.03). Although there are more than three CRAs in the EU, credit ratings tend to be aligned²¹ and these three CRAs account for a significant share of the overall market. EU Member States were then split between three categories:

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

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

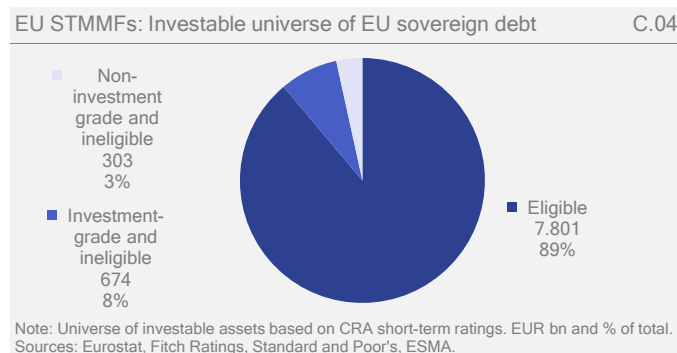
Short-term rating eligibility for EU STMMF	T.03		
	Fitch Rating	Moody's	S&P
Eligible under CESR Guidelines	F1	P-1	A-1+
			A-1
	F2	P-2	A-2
Ineligible	F3	P-3	A-3

²¹ Annalisa Croce, Stefano Lugo and Robert Faff (2011), “Rating alignment, Rating shopping and Reputation of credit rating agencies: evidence from the subprime crisis”.

B, C
 RD, D
 Not Prime
 B, C
 SD, D

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

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



The case of Spanish (ES) government bonds in October 2012 provides an instance of sudden reduction in STMMF investable universe and potential cliff effect. ES government bonds account for 7.6% of all EU sovereign debt securities (EUR 669bn) and a significant portion were eligible for STMMF investment until the October 2012. On 12 October 2012, ES's short-term debt rating was downgraded by S&P's from A-2 to A-3, effectively making all ES sovereign debt securities ineligible overnight for EU STMMF investments.²²

Currently, there are eight Member States with a short-term rating of A-2 from S&P and a rating of F2 or higher from Fitch Ratings (T.04). In each case, a hypothetical downgrade by S&P would result in ineligibility of the sovereign debt stock for STMMF investment. Such a hypothetical rating action on any individual Member State would further reduce the investable universe of STMMFs

²² In addition, given the alignment of many non-sovereign debt ratings to the sovereign and that several banks are in the process of being recapitalised, the overall reduction in investable universe may be even larger than the impact in the sole area of sovereign debt securities.

by between EUR 3.9bn and 1,655bn (in the latter case, this would amount to 18.9% of total EU sovereign debt securities). In an extreme case, a hypothetical downgrade of all A-2 rated Member States would lead to an equivalent reduction of the investable universe by around 1.9tn.²³

EU sovereign debt securities and short-term ratings			
	Amount	S&P	Fitch
AT	185,116	A-1+	F1+
BE	330,132	A-1+	F1+
BG	4,929	A-2	F3
CY	9,186	C	B
CZ	62,651	A-1+	F1
DK	91,837	A-1+	F1
EE	246	A-1+	F1
ES	669,027	A-3	F2
FI	83,020	A-1+	F1
FR	1,546,058	A-1+	F1
DE	1,547,158	A-1+	F1
GR	93,614	SD	B
HU	59,118	B	B
IE	89,289	A-1+	F1+
IT	1,655,283	A-2	F2
LV	3,866	A-2	F2
LT	10,671	A-2	F2
LU	5,000	A-1+	F1+
MT	4,477	A-2	F1
NL	331,257	A-1+	F1+
PL	181,244	A-2	F2
PT	110,661	B	B
RO	30,899	B	F3
SK	32,799	A-1	F1
SI	16,252	A-2	F2
SE	119,194	A-1+	F1+
UK	1,505,769	A-1+	F1

Note: As of end-2012, EUR mn. Moody's short-term ratings were left out due to limited availability.
Source: Eurostat, Fitch Ratings, Standard & Poor's.

²³ In addition, mechanistic reliance may have the undesirable consequence of STMMFs anticipating potential future downgrades and assets ineligibility, with some MMFs reducing early their holdings of government and/or private sector debt, thereby affecting the liquidity position of the sovereign and/or private entities and adding to the pressure on their creditworthiness.

2. The Standardised Approach under CRD IV legislation²⁴

Under the CRD IV/CRR, credit institutions have the choice between two approaches for the calculation of own funds requirements for credit risk: the Standardised Approach (SA) and the Internal Ratings Based approach (IRBA).

The SA is widely used among European banks. While many institutions rely fully on the SA, also banks using the IRBA tend to have significant exposures under the SA, subject to the partial use requirements in the CRR. A recent study by the EBA found that out of a sample of 89 IRBA banks that on average 30% of risk weighted assets stemmed from the SA.²⁵

Consequently, the potential impact of prohibiting the use of external ratings could be substantial, given the wide usage of the SA. However, in many cases the own funds requirements under the SA do not depend on the use of external ratings, as is explained in detail below. Further, given that the Guidelines do not propose any changes, at this point in time, there will be no immediate impact of this proposal.

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

However, it has to be noted that in many cases external ratings are not available for exposures falling within the abovementioned exposure classes and/or that the current rules of the CRR already provide incentives not to use external ratings:

Exposures to Member States' central governments and central banks will always receive a 0% risk weight, regardless of an external rating of the respective Member State. With this rule a large portion of banks' exposures to sovereigns and central banks will already be covered without the reliance on external ratings. In addition, banks may use the credit assessments by Export Credit Agencies for the purpose of determining the own funds requirements for exposures to central governments or central banks. Only in all remaining cases, the capital requirements may be connected to external ratings, the most notable example being the exposures in the form of US governments bonds.

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

²⁴ Regulation EU No. 575/2013 (CRR) and Directive 2013/36/EU.

²⁵ [Review on the consistency of Risk Weighted Assets, First interim Report on the review of the consistency of risk-weighted assets.](#)

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

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

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

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

Annex III: References to credit ratings in the Solvency II Directive

Article 141 UECAI2

(Art. 109a of Directive 2009/138/EC)

General requirements

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

(5) For the purpose of paragraph 4, the larger or more complex exposures of an undertaking shall include tradable securities or other financial instruments based on repackaged loans and those defined in the implementing technical standards adopted in accordance with Article 111(c) of Directive 2009/138/EC. Article 142 UECAI₃

(Art. 109a of Directive 2009/138/EC)

Issuers and issue credit assessment

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

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

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

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

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

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

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

Article 142bis UECAI_{3bis}

(Art. 109a of Directive 2009/138/EC)

Double credit rating of tradable securities or other financial instruments based on repackaged loans

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