Joint Committee of the European Supervisory Authorities

JC Mechanistic References to Credit Ratings in the ESA's guidelines and recommendations

27th November 2013

Dear Sirs

The following response to your request for comment on JC-CP-2013-02 is provided in my capacity as a representative of Avantage Reply, a pan-European specialised risk and regulatory management consultancy firm.

The responses represent the collected views of our UK practice and provide a perspective based on UK firms only. Furthermore, in this instance, we have only sought to respond to the JC from the perspective of the Banking sector.

For clarity, we have repeated the questions for consultation in ***purple italic text.*** *O*ur responses are in standard black test.

We would be very happy to discuss any part of this response with you in more detail if you wish.

Yours faithfully

Will German

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

Article 5b(1) of the CRA regulation[1] 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.

The CRA Regulation does not include a formal definition of "sole or mechanistic reliance"; however, the 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"...

The Consultation considers the discretion for a firm to deviate away from use of the external rating to be a key mitigating factor in determining whether mechanistic reliance exists.

We agree that the proposed definition is reasonable. However, in shaping the CRA Regulation, the European Commission (EC) has indicated that it would be desirable to reduce so called "cliff effects", which it defines 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. We consider that granting firms discretion to deviate away from the use of external ratings will only achieve the ECs objective if the discretion is likely to be sufficient to reduce the frequency and impact of cliff effects.

Taking the example of banks using the Standardised Approach, we don't consider that the discretions available will achieve this objective, as:

1. We expect the ability of EEA member states to opt for more stringent requirements[2] under the CRR[3] to still lead to cliff edges for banks using the Standardised Approach as we expect most member states with material banking sectors to adopt the minimum standards in order to remain competitive.
2. Where member states do opt for more stringent standards, this will still lead to cliff edges at a National level.
3. Where "more stringent standards" is interpreted as simply "a higher risk weight than proscribed for a given ECAI rating", this will continue to result in cliff edges at given credit quality steps.
4. We don't expect individual firms using the standardised approach to opt individually for more stringent standards as A) this will result in competitive disadvantage and B) by definition, these firms lack the sophistication, data or appetite develop their own internal models and so are likely to default to the proscribed approach.

[1] Credit Rating Agencies - Regulation (EC) No 1060/2009, amended by Regulation (EU) No513/2011 and by Regulation No462/2013

[2] CRR Article 3

[3] Capital Requirements Regulation - Regulation (EU) No575/2013

5. The ability of institutions to assign higher risk weights to items with particularly high risk[4] only applies to a limited range of assets that may or may not be prevalent in portfolios using the standardised approach.
6. The mandate granted by the CRR for the ESA to draft Implementing Technical Standards specifying mapping ECAIs to credit quality steps will not reduce the incidence of cliff edges, nor will the periodic review of the mappings on the basis of CRA rating's historical performance.

With this in mind, we do not consider that the availability of additional discretion is sufficient to confirm that reliance is not mechanistic unless the discretion is sufficient to meaningfully mitigate the risk of "cliff edge effects". We note that the Consultation Paper concludes that despite the arguments put forward, it considers the reliance on credit ratings under the standardised approach to be at least partially mechanistic.

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

We entirely agree with the ESA's assessment that it is not appropriate to repeal or amend the guidelines to remove the reference to external ratings. Until the Basel Committee Taskforce on the Standardised Approach's work to find alternatives for replacing the mappings to external ratings progresses, we can see little alternative except to replace the risk weights graduated by credit quality step with flat risk weights per exposure class. This would be less risk sensitive than using the existing approach and could lead to perverse incentives for firms, which could present greater idiosyncratic and systemic risks than presented by the current approach.

We note that in the UK there is significant political support for the establishment of "challenger banks" to increase competition and challenge the hegemony of the UK's "too big to fail" institutions. Although cognisant of the CRD IV provisions requiring Competent Authorities to encourage significant institutions to migrate to the IRB based approach, we consider the Standardised Approach to still have a significant role to play for up and coming challenger banks, less sophisticated institutions and less material portfolios in larger firms. We therefore support the ESA's approach to leave the approach unchanged at this point.

We note that the ESA's assessment does not include consideration of Article 202b of the CRR which relates to the "double default benefit" provided by unfunded credit protection and requires providers of unfunded credit protection to:

…"be regulated in a manner equivalent to the rules laid down in this Regulation, or had, at the time the credit protection was provided, a credit assessment by a recognised ECAI which had been determined by EBA to be associated with credit quality step 3, or above, in accordance with the rules for the risk weighting of exposures to corporates set out in Chapter 2"…

This requirement also has the potential to create "cliff edges" and potentially systemic shocks where significant unregulated unfunded credit protection providers are

[4] CRR Article 128

downgraded. We suspect (although do not have the data to confirm) that this population is not material and so agree with the ESA's (implied) view that no change is required.

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

We have only commented on this proposals from the perspective of the banking sector and so have not responded to this section.

We are of course, happy to discuss any of the comments above in more detail.