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Joint Committee of the European Supervisory Authorities
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Re: Mechanistic References to Credit Ratings in the ESA's Guidelines and Recommendations (JC-CP-2013-02)

Dear Sirs,

CFA Institute appreciates the opportunity to respond to the Joint Committee of the European Supervisory Authorities (EBA, EIOPA, and ESMA) consultation paper on mechanistic references to credit ratings in the ESAs' guidelines and recommendations (the "consultation").

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 120,000 members in 139 countries and territories, including 115,000 Chartered Financial Analyst® charterholders, and 139 member societies.

Summary

We support the objective of the consultation (and the CRA3 Regulation) to remove references to credit ratings in the ESA's guidelines, recommendations, and technical standards where such references could lead to sole or mechanistic reliance on credit ratings. One of the problems associated with the run-up to the financial crisis was the undue faith and reliance placed on credit ratings by some financial market stakeholders. This situation resulted, in some cases, with stakeholders effectively substituting independent due diligence for external ratings when assessing the credit quality of securities.

There has been undue prominence attached to credit ratings in the financial system, both among financial market stakeholders and within legislation and regulation. Removing "mechanistic" references to credit ratings in legislative and regulatory documents should therefore alleviate excessive reliance on ratings and should encourage market participants to attach more weight to other forms of credit risk assessment.

Specific Comments

The consultation outlines instances of references to credit ratings that the ESAs consider to be mechanistic. These instances relate only to EBA guidelines on the Standardised Approach to determine risk weights in relation to credit risk exposures under the CRD IV legislative package, and ESMA guidelines on money market funds (MMFs). Our responses to the consultation questions are set out below.

CFA Institute

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

The consultation provides the following definition for sole or mechanistic reliance:

"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."

In our view, the definition is reasonable. It captures the essence of an action stemming from a rule based singularly upon credit ratings (thus ratings are the sole criterion for determining the action); additionally, the explicit absence of discretion captures a mechanistic action.

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

Under the Capital Requirements Directive IV legislative package[1], the Standardised Approach requires banks to use ratings from external credit assessment institutions (ECAIs) to determine the required capital for credit risk exposures. The consultation notes that the legislation introduces the concept of Credit Quality Steps (CQS) which are related to ECAI ratings via a mapping that is specified in EBA guidelines. Therefore, an external rating change that triggers a change in the CQS to compute risk weighted assets is considered by the ESAs as mechanistic because institutions cannot rely on alternative credit assessments in this circumstance.

Further, the consultation also notes that the CRR introduces a mandate for the ESAs to draft implementing technical standards (ITS) specifying the mapping of the ECAIs to the CQS, and that this ITS will repeal the EBA guidelines once in force.

Because the mechanistic reliance is intrinisic in the Basel III framework (and is therefore not a product of the ESAs) and because the EBA guidelines triggering the mechanistic reliance will be repealed by ITS, the consultation stipulates that the ESAs do not consider it appropriate to make any changes to EBA guidelines at this time.

We agree that this is an acceptable approach. We also support the sentiments expressed in the consultation that further work is needed at the international level to examine the mapping to external ratings in the Standardised Approach.

ESMA guidelines containing mechanistic references to credit ratings comprise guidelines on MMFs only. Our comments on these guidelines are are provided in our response to question 3.

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

ESMA's MMF guidelines on a common definition of European money market funds (developed by ESMA's predecessor, CESR)[2] are considered to include mechanistic references to credit ratings in two places. Firstly, under the guidelines, a money market instrument is not considered to be of high quality unless *"it has been awarded one of the two highest available short-term credit ratings by each*

[1] The CRD IV legislation, which implements Basel III in the EU, comprises a directive (CRD) and a regulation (CRR).

[2] http://www.esma.europa.eu/system/files/10_049.pdf

recognised credit rating agency that has rated the instrument". Secondly, as an exception to this rule, a MMF may *"hold sovereign issuance of at least investment grade quality."*

In CFA Institute's December 2009 response[3] to CESR's consultation paper on these guidelines, we commented that:

"We oppose the option contained in the definition that would, in effect, prohibit investment in securities not rated by a credit rating agency. This option would entrench the use of credit ratings in both the investment policy of the fund and in regulation, which would contradict the wider regulatory objective (as part of the package of regulatory reforms of credit rating agencies) to reduce the reliance on credit ratings. Such a move would also contradict international efforts, such as those in the United States, to remove references to credit ratings in regulation where applicable. The initiative to reduce excessive reliance on credit ratings also emphasises the importance… for managers to consider other factors in addition to credit ratings when assessing the quality of an instrument."

Though we are disappointed our December 2009 comments were not heeded when these guidelines were developed, we are pleased that the ESAs are now addressing this issue.

ESMA's proposed revisions to the guidelines are paraphrased below. In our opinion, it is appropriate for the guidelines to refer to credit ratings as a factor that could be used by the management company when performing its own credit risk assessment, but the guidelines should not mandate the use of credit ratings. Such an obligation risks entrenching mechanistic behaviour with regard to credit risk assessment. Consequently, we believe that ESMA's proposed language could go further to remove the risk of mechanistic reliance.

To remove this risk, we urge ESMA to give due consideration to the following suggested edits (shown in bold underline):

Paragraph 4 of Box 2:

"*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. **One of the factors that s**~~S~~uch an assessment ~~sh~~**c**ould have regard to **is** 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 **be a factor that would** 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."*

Paragraph 2 of Box 3:

""[…]

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. **One of the factors that s**~~S~~uch an assessment ~~sh~~**c**ould have regard to **is** the credit rating(s) provided by one or more credit rating agencies registered and supervised by ESMA.*

[3] http://www.cfainstitute.org/Comment%20Letters/20091221_2.pdf

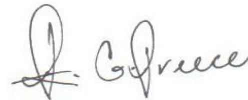
While there should not be mechanistic reliance on such external ratings, any downgrade below investment grade by such an agency should ***be a factor that would*** *lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of appropriate 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."*

We believe these edits improve the language and mitigate any residual risk of sole or mechanistic reliance on credit ratings in ESMA's MMF guidelines.

Concluding Remarks

CFA Institute welcomes the initiative to remove references to credit ratings in the ESA's guidelines, recommendations, and technical standards where such references could lead to sole or mechanistic reliance on credit ratings. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,



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