EACRA comments on ESRB Chair letter to EC and ESMA on procyclical impact of downgrades

With reference to the ESRB Chair's public letter[1] to the European Commission and ESMA, both members of the ESRB, dated October 1st, 2020 on "procyclical impact of downgrades of corporates bonds on markets and entities across the financial system", EACRA wishes to comment on the two key topics raised. The letter mainly refers to ratings in investment mandates and the lack of competition in the rating market, potentially amplifying rating downgrades by the S&P, Moody's and Fitch (the "Dominant Agencies") into a systemic risk reducing financial stability.

In view of the COVID-Pandemic, European Institutions[2] and Member States[3] took a great number of measures to reduce the burden of the crisis on the society and the financial system as a whole. But, these reductions in capital requirements to banks were not able to outbalance the impact of rating downgrades[4].

The impact of these downgrades is essentially due to the oligopolistic structure of the rating market. While the last amendment of the CRA Regulation dating back to 2013 had as an objective to increase competition in the rating market, 7 years later, the Dominant Agencies still have more than 92%[5] of the market - EACRA therefore believes that stronger actions are required and that it is a shared responsibility of issuers, investors, central banks and policy makers to make the market more competitive. While issuers and investors regularly complain about the pricing policies of the Dominant Agencies using the "everybody-pays model"[6], market share is still low for European agencies. We highlight that European agencies have substantially invested in recent years to expand their coverage and currently employ together more than 50% of all staff in the EU 27 rating industry.

One area that ESRB finds concerning is existing contractual references to ratings in investment mandates and fire sales linked to these. EACRA believes that references to ratings should be reviewed to cover also a crisis period where the investment firm could evaluate different options instead of making mandatory sales to comply with the standards. As an example, the ECB relaxed the

[1] Available at: https://www.esrb.europa.eu/pub/pdf/other/esrb.letter201001_impact_of_downgrades_of_corporate_bonds~d15087499d.en.pdf

[2] For a full review, please consult the summary by the EP Secretariat available at https://www.europarl.europa.eu/RegData/etudes/IDAN/2020/645723/IPOL_IDA(2020)645723_EN.pdf

[3] As an example, the majority of Euro Area Member States have relaxed the Countercyclical Capital Buffers requirements with only 2 Euro Area Member States having currently positive rates. See page 2 of https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/645712/IPOL_BRI(2020)645712_EN.pdf

[4] While the countercyclical capital buffer is deigned to counterbalance cyclical changes and may range between 0 and 2,5% of additional capital requirements, the level before the pandemic was too low to absorb the impact of the crisis.

[5] See ESMA CRA Market shares report dated November 2019.

[6] While the dominant agencies state that they use the "issuer-pays" model, these agencies also charge investors for the usage of rating data feeds.

minimum credit quality requirements for its ECAF[7] and PEPP in order to mitigate the impact of rating downgrades. Additionally, since existing references to ratings are firmly established over a longer time period and usually refer to one or several of the Dominant agencies with specific rating levels, investment funds should review their reference to ratings in order to define minimum rating quality according to sectoral legislation (e.g. a Credit Quality Step). EACRA believes that references to ratings should be made generic and compatible to all ESMA registered CRAs as eligible ECAIs, and that a policy defining the nomination of ECAIs[8] should be implemented.

European CRAs do not fully substitute the global coverage of the Dominant Agencies[9], but they can be more than a complement to the Dominant Agencies on European exposures. By referencing European CRAs, investment firms may expand the potential investment universe (as European CRAs frequently cover assets not covered by the dominant agencies), gain additional insight into exposures from a European perspective, reduce cliff effects and provide for capital reliefs.

With respect to banks, we note that some banks disclosures under Pilar III regarding the use of ECAIs under Article 444 of CRD still include references to national competent authorities or even to CEBS. Given that the ECAI status is a European Economic Area wide designation since January 2014, we call on banks to review their nominations of credit rating agencies / ECAIs: nominating more ECAIs reduces the reliance on single agencies and contributes to financial stability[10].

Central banks should equally review their reference to ratings. At present, the ratings issued by European agencies are not used by the ECB. EACRA proposes that the ECB takes a more inclusive approach and uses a reverse due-diligence on entities rated by European agencies to confirm their eligibility for collateral or purchase operations[11].

In view of the skewed market shares, with limited evidence of increased competition in the rating market in Europe, it is clear that the voluntary provisions do not suffice to change overall behaviour. Policy makers should amend compulsory regulatory requirements in order to increase competition. The need for a larger competition in the credit rating market should be addressed as an important focus area for European authorities to reduce systemic financial risks, taking in consideration all market players and their potential contribution to the issue.

About EACRA

The European Association of Credit Rating Agencies (EACRA), set up in November 2009 and registered in Paris, was established to act as a platform for cooperation for EU-based Credit Rating Agencies (CRAs). Our mission is to support and facilitate the compliance of CRAs with regulatory requirements through effective communication, cross-border know how, and the promotion of best

[7] See https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200422_1~95e0f62a2b.en.html

[8] Such a policy may include the coverage of a CRA, performance of CRA, pricing of rating data feeds etc

[9] 73% of all ratings issued by the dominant CRAs and used by European investors are ratings produced outside of the European Union and endorsed into the EU for regulatory purposes.

[10] Based on our research, we note that banks tend to nominate more ECAIs the larger and complex the bank is.

[11] For more information, we refer to our response to the ECB Monetary Strategy Review dated October 30th. 2020 available at: http://www.eacra.fr/sites/default/files/EACRA%20response%20ECB%20Strategy%20Review.pdf

practices. In addition, EACRA seeks to promote Credit Ratings and the interests of CRAs across Europe, as well as enhance the financial community and general public's understanding of Credit Ratings.