Exploratory study on the use of credit ratings in the Netherlands

The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

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Preface

Since the credit crisis started in 2007, credit rating agencies (CRAs) are criticised for their performance. They were accused of rating structured finance instruments, such as asset backed securities, inaccurately. When the underlying assets eventually turned out less creditworthy, it led to large downgrades. The question rose if the CRAs were biased in their rating due to potential conflicts of interest such as pressure from issuers or due to lack of competition.

In the EU, the first CRA regulation (1060/2009/EU) entered into force in 2009 with the intention to mitigate those threats. The regulation's first recital cites the use of ratings as follows: "Credit rating agencies play an important role in global securities and banking markets, as their credit ratings are used by investors, borrowers, issuers and governments as part of making informed investment and financing decisions."

Primarily, CRAs were supervised by European colleges of national regulators. From 2011 on, the CRAs have become under supervision of ESMA, the European Securities Markets Authority. The second CRA regulation (513/2011/EU) made this possible.

As the crisis continued and became a sovereign debt crisis in Europe, renewed attention was given to the CRAs. This time CRAs were accused of downgrading sovereign ratings too quickly. New rules came into force in 2013 in the third CRA regulation (462/2013/EU). This third regulation (CRA-3) does not only regulate CRAs but also users of ratings. It introduces some new topics, such as[1]:

- Reducing the sole or mechanistic reliance on ratings;
- Information to be provided on structured finance instruments (SFI's);
- Mandatory rotation of CRAs for re-securitisations;

With these provisions in the third CRA regulation, some new supervisory tasks were introduced for authorities such as the AFM. One of the main items in CRA-3 is the article on over-reliance on credit ratings (article 5a). Authorities such as the AFM have to monitor financial institutions on the adequacy of their credit risk assessment processes and the use of contractual references to credit ratings.

The AFM conducted this study in the second half of 2013 in preparation of those tasks. We considered it useful to gain a broader insight into the use of credit ratings in the Netherlands. This study also helps preparing for the review of CRA-3 which will take place from 2015 on. Furthermore, the FSB is giving more and more attention to the use of credit ratings on a global level.

For this exploratory study we held multiple interviews with market participants from both buy and sell side, financial infrastructures, governmental bodies and with our colleagues internally and from the Dutch Central Bank. We would like to thank them all for their time and willingness to share information.

[1] *See chapter 6 for the overview of parts of the new legislation. The full text of CRA-3 can be found at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:146:0001:0033:EN:PDF*

1 Study outline

1.1 Scope & objectives: The use of ratings in the Netherlands

Many studies and articles are already written on ratings and the inherent conflict of interest surrounding them. Most of those are at an aggregated level with a European or US perspective. The objective of this report is to give some insight into the use of credit ratings in the Dutch market and to show our results with regard to the reliance on ratings in the Netherlands.

The AFM explores the influence of external credit ratings, the users of ratings and the purpose of use. We started this study in order to develop a position for future discussions on the removing of references to ratings. Furthermore this report will help with the upcoming obligation from CRA-3 to monitor parties with an AFM license and parties or instruments for which the AFM is the national competent authority.

The report is based on a limited literature study and interviews with relevant parties in the Dutch market that are using ratings. In addition to the interviews, some relevant questions were incorporated in the self-assessments for investment firms, collective investment schemes and in the consumer monitor of the AFM, which can be found in Annex 2 and 3. A preliminary overview of who uses ratings in what manner can be found in the table in Annex 1.

1.2 Credit rating definition

To limit the scope of this study, we only take into account credit ratings as defined in the CRA regulation as "an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories." This definition is applicable in this report whenever there is referred to 'ratings'.

Although the determination of what a credit rating is differs between CRAs, and therefore the ratings do not represent the same measurement, we use them interchangeable. For example, S&P ratings measure the probability of default, whereas Moody's ratings measure expected loss[2].

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2 More information can be found on the websites of several rating agencies: -

https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004,

http://img.en25.com/Web/StandardandPoors/SP_CreditRatingsGuide.pdf,

https://www.fitchratings.com/creditdesk/public/ratings_defintions/index.cfm

1.3 Report

To structure the study, some broad categories are defined. These are derived from our preliminary overview of the users of ratings and the purpose why ratings are used (Annex 1):

- Ratings to determine counterparties (chapter 2);
- Ratings as a tool for investment limits (chapter 3); and
- Decision making based on ratings (chapter 4).

All other use of ratings that does not fit in one of these categories and the new legislative framework are described in chapter 5 and 6. The conclusions can be found in chapter 7. The Annexes contain an overview of users and purpose and additional information on the self-assessments.

2 Ratings to determine counterparties

Within financial transactions such as securities transactions, money market transactions, swaps, derivatives and FX transactions, it takes two counterparties to conclude a transaction. Ratings, both short and long term, are often used to determine the eligibility of counterparties. The credit rating of a party can be a deciding factor with regard to the question if business can and will be done with this party. The rating is especially relevant for money market and derivative transactions to determine if a counterparty qualifies in case a minimum rating is required by internal procedures. During the credit crisis, downgrades of some SIFI banks below single A led to a reduced number of eligible counterparties due to internal constraints. If a counterparty qualifies, the rating can also be used to determine the amount of collateral demanded (including haircuts).

From the AFM self-assessments (see Annex 3), this use of ratings is substantiated by the fact that out of the 241 respondents 118 investment firms indicate they use ratings for this purpose. Some of the collective investment schemes indicated (11%) to use ratings for assessing counterparty risk when they are involved in for example OTC trades.

2.1 Money market

(National) banks and treasuries, both private and public, deposit their excess cash overnight or for a longer term in the money market. This can be done by lending out the cash or by investing in for example exchange traded instruments. Determining the counterparty risks in an easy and quick way is especially important for investors with limited resources that want to deposit their temporary surplus without too much risk taking and as a tool for risk diversification. To determine where to deposit the excess cash, banks and treasuries take credit ratings into account as one of the decisive factors.

2.2 OTC derivative transactions

Ratings are often used in the inter-banking market to determine counterparties and counterparty risk for derivative transactions. Estimating counterparty risk correctly is especially important for swaps, because parties can have a large and long maturity exposure on each other.

The ISDA master agreement is the most used agreement for OTC derivative transactions.[3] There is an indication that the number of eligible counterparties with whom ISDA agreements are agreed upon is declining, due to downgrades of certain large international banks. Many banks only enter into ISDA contracts with counterparties that have a rating from a CRA. Preferably the counterparty has to have at least two ratings. A downgrade in the rating of the counterparty can trigger a

[3] *The ISDA master agreement, published by the International Swaps and Derivatives Association, is a document agreed between two parties that sets out standard terms that apply to all the transactions entered into between those parties. It is set up to ensure legal certainty on a global level.*

termination event of the ISDA agreement if lowered below the upfront stated limit. For ISDA agreements, the counterparty should have an investment grade (at least BBB- or Baa3). Otherwise it might lead to termination of the contract, higher margins, cash payments or additional guarantees.

2.3 Credit assessment (CCPs)

Previously only transactions on trading platforms were cleared through a central counterparty (CCP). Under EMIR, certain types of standardised derivatives contracts will also have to be cleared through a CCP. To become a clearing member (counterparty) of a CCP, the CCP will conduct a credit assessment. CCPs use ratings in their credit assessment but on a relatively small scale and solely as one of the inputs in their model. A party can become a clearing member when the internal model of the CCP indicates that a party has at least a certain score. One CCP indicated that external credit ratings have a weight of less than 10% in their internal credit score.

2.4 Collateral, margin and haircuts

Collateral management is directly linked to the counterparty risk determination and therefore relevant as well. In this paragraph on collateral and margining there are two ways in which an external rating can play a role. First, the rating of a party posting initial margin can be used as one of the input factors for the initial margin determination of the counterparty risk. The lower the rating, the higher the perceived risk and its corresponding margin.

Second, depending on the type of collateral, pledged assets have a certain rating, especially if not being cash. To be accepted, these assets must be eligible, i.e. fulfil certain criteria on for instance liquidity and volume. The annex of an ISDA master agreement contains provisions regarding the type of collateral that can be used. Most central banks have minimum rating requirements for the issuers of any potential collateral. Other parties also take ratings into considerations when determining if certain collateral can be accepted.

Within collateral management, haircuts are used as a percentage that is subtracted from the market value of an asset that is being used as collateral. The size of the haircut is determined by the perceived risk of the asset. To determine the risk, credit ratings are taken into account. The ECB for example applies haircuts to all offered collateral not being Euros. The size of the haircut on the security depends on the perceived risk and liquidity of the security.

2.5 Example: the Dutch treasury

The Dutch State Treasury Agency of the Dutch Ministry of Finance is responsible for the management and financing of the public debt, the treasury banking for public entities related to the government and the payments of the state. If the treasury needs to make an overnight deposit, the maximum amount that can be deposited with a counterparty mostly depends on the size and credit rating of the counterparty.

3 Ratings as a tool for investment limits

3.1 Asset management

Credit ratings can play a role in the advice towards retail investors or customers in for example their composition of an investment portfolio. The asset allocation determination depends on expected yield levels and risk appetite. Furthermore, it is an easy way of explaining differences in risk profiles of investments. Advice with the inclusion of ratings can be given by banks, a financial planner or an investment firm.

In the asset management's world, limits are necessary for an investor. These limits are both geographical, industrial, based on risk appetite and dependent on the goal of the investor, combined in the investment (risk) profile of the client. One of the more convenient ways of limiting the scope of the investments is by determining what a minimum or maximum rating should be. This is likely linked to the risk and yield search but is a more formal way to bind an asset manager.

From conversation with market participants, most respondents agreed that mandates given to asset managers mostly have a reference to (a) rating(s). Our self-assessment supports this as 34% of the investment firms use ratings in their mandates and 51% use them in their advice towards clients (see Annex 3). This reference is one of the input factors and gives some flexibility on what the effect of a rating downgrade is. For example, a grace period of 3 to 6 months is built in, or 2 out of 3 ratings need to be downgraded before any action will be taken. Other mandates leave more room for asset managers to keep the security in the portfolio but prohibiting buying more of the asset.

3.2 Overnight investment/money market funds

Ratings are one of the tools used in the money market. On short term money market investments, ratings are used to decide where investments are placed and for what amount. For short term investments, a separate rating from the CRAs is available reflecting the obligor's creditworthiness for a shorter period of time.

3.3 Fund structures such as ETF

Exchange traded funds (ETFs) depend to a large extent on ratings. For example if the prescription of a fund is 'investment grade'. A fallen angel, from investment into speculative grade, has a direct impact on the fund and will lead to a change of the ETF composition. Therefore a downgrade below investment grade leads to the necessity to sell those assets as soon as possible. For other funds, there might be a grace period to allow for a sale, to check on a review of the ratings by the CRA or to change the asset or bond into another fund where its characteristics fit into the structure of the fund.

3.4 Example: local government rules

Local governments have specific investment rules determined by law which prescribe the minimum rating needed to be able to invest (temporary) excess liquidity. When entering into a derivatives contract, the Dutch so called RUDDO-rules lay down that at least a AA-minus rating from at least 2 CRAs is necessary or for a short term of maximum 3 months at least a A-rating is needed.[4]

4 Please find the RUDDO rules at http://wetten.overheid.nl/BWBR0012076 (in Dutch) However, these rules do not apply if the investments have a solvency ratio of 0% such as certain sovereign bonds.

4 Decision making based on ratings

Credit ratings can be used by the investors to make investment decisions and to gain insight into the financial status of a company. Debtors and investors will take, among others, creditworthiness and yield into consideration when determining if an investment might be a good decision. Ratings are therefore important in the investment decision making process, mainly in the fixed income market. Ratings are both an input factor in (internal) models and a 'quality stamp' that a third party independently qualifies the issuer or instrument.

4.1 Comparability of investment

Markets are characterised by information asymmetry. Credit ratings can be seen as a means of levelling out this asymmetry and to provide investors with relevant information on a company, instrument or country. A rating is easy to understand, has a known scaling and a CRA has (mostly) the availability of relevant non-public information. CRAs review a company or country, add quantitative and qualitative information to their model, form an opinion, create a rating based on that model and write the underlying report. Due to the same methodology for comparable investments, ratings are a valuable information source. Furthermore, the opinion of the CRA should be more neutral than the information a company or country would present to the market about itself, provided it is free of conflicts of interest.[5]

Most credit ratings are a measure of relative credit risk, depending on the method used by the CRA. Credit risk is mostly linked to the ability of an issuer to repay the debt within the time stated in the conditions. High creditworthiness is linked to a higher rating. In principle, a lower rating implies a higher risk and will lead to a higher yield. The risk appetite influences whether an investor decides to make an investment looking at the risk/return yield.

The results of the self-assessment for investment firms (Annex 3) show that ratings are indeed used for model and/or reference portfolios.

4.2 Quality seal

One of the main goals why issuers would like to receive a rating at all, is to be able to finance themselves on the capital market. A rating gives an indication on the interest to be paid, measures the probability of default or expected loss and shows a third party's assessment of the creditworthiness.

Ratings can increase the liquidity of a fund or obligation, because it can be seen as a quality seal. Market participants admit that a prospectus without a rating is seen as odd and might flag some concern upfront. Especially for structured finance instruments, ratings are common and preferably from one of the large CRAs (e.g. S&P's, Moody's, Fitch and DBRS).

[5] *We will not enter into reasons for conflicts of interest at the CRA in this survey.*

A rating does not only give some insight into the notch of quality a structured finance instrument, but also on comparability between different instruments with a similar structure. This leads to exchangeability of structured finance instruments which could turn into higher tradability.

In addition, it is relevant to notice that structured finance instruments can have a higher rating than the underlying originator due to the structure of the instrument (tranches) and that only limited risks are beard from the originator leading to less credit risk.

4.3 Capital requirements

Capital requirements for banks are put into place to ensure the stability of the financial sector. The Basel Accords have established rules around capital requirements and requires that banks have a minimum amount of equity for all loans provided. The amount of equity used to be dependent on the credit rating from a CRA approved as External Credit Assessment Institutions (ECAI). Basel III assessed a number of measures to mitigate the reliance on external ratings of the Basel II framework. These include requirements for banks to perform their own internal assessments of externally rated securitisation exposures and the elimination of certain 'cliff effects' associated with credit risk mitigation practices. Such cliff effects mean the sale of assets solely due to the changed credit rating.

Two types of models can be distinguished for banking balance sheet under the Capital Requirements Directive/Regulation (CRD and CRR). The internal ratings based approach (IRB) is mainly used by large institutions to determine its risks weighted assets The IRB model takes into account credit ratings for risk weighting but only as one input factor among others. The IRB model is relatively complicated, gives more room for specific risk determination but also requires quite some effort to determine the risk weights. Due to its complexness and their limited resources, it is not reasonable for small financial institutions to also use an IRB model. Therefore small(er) financial institutions can use the standardised approach (SA). This model has categorised exposure classes such as sovereign and corporate and determines the accompanying risk weights. The accompanying quality determinants are directly related to external credit ratings. Therefore banks using the SA will have a larger reliance on ratings in their model.

4.4 Retail investors

The AFM conducts a bi-yearly survey under consumers to explore i.a. their investment behaviour (the 'consumer monitor'). The results of last year's AFM survey conducted amongst 681 consumers that are also retail investors (please refer to Annex 2), show that a significant part of these consumers/retail investors uses credit ratings. Almost 2 out of 5 retail investors indicate that they take credit ratings into account for the decision to purchase or sell investments. When retail investors use an advisor for investment decisions, more than half of the retail investors that took part in the survey take credit ratings into consideration. When credit ratings are used, 3 out of 5 consumers in the survey state that ratings are a key determinant. An analysis of the results further shows that if a retail investor has more assets under management, it is the more likely that he takes credit ratings into consideration.

For more than half of the retail investors that invest using an asset manager, credit ratings are not part of the agreement with the asset manager. Only 7 per cent of the consumers that invest by using an asset manager indicate that they are certain that credit ratings are a part of the agreement with the asset manager. However, 38% of the same population does not know whether credit ratings are part of their agreement. For a visual presentation of the relevant results of the AFM consumer questionnaire please refer to Annex 2.

4.5 Investment firms and collective investment schemes

In the relation between decision making and the use of ratings almost 30% of the investment firms stated that there is no relation, as they indicated not to use ratings at all. For collective investment schemes this percentage is almost 66%. The research results also show that those schemes that do use ratings do this mostly with the intention to select underlying values. For investment firms it shows that 36% of the respondents indicate that they use ratings in their advice towards (retail) clients. This could be seen as one of the parameters of influence to an investment decision.

5 Other use of ratings

After describing the use of ratings in terms of counterparty determination, investment limits and rating based decision making, there are some other ways to use ratings which do not fit into one of these broad categories. These references are still relevant to paint the full picture of rating use in the Netherlands. This Chapter contains a short overview.

5.1 Stress testing

References to ratings can be found in different stress testing models. For example, shocks to be absorbed when investing in emerging countries and being able to manage country risk. Among other determinants, banks should have enough capital available to absorb a three notch downgrade of a sovereign rating from the emerging country.

Another example is the internal liquidity adequacy assessment process (ILAAP). Banks need to be able to absorb a two notch downgrade in three months in their market stress scenarios made for the internal liquidity adequacy assessment process.

5.2 Trigger event

In ISDA documentation reference to ratings can be made in the additional termination events (ATE) listed in the Schedule. A ratings-based ATE clause gives a counterparty the right to close out all derivatives contracts with a given financial institution if the institution's rating falls below a specified level above default, or, in some cases, is withdrawn by one or more rating agencies.[6]

Furthermore, downgrades can result in a trigger event. A useful example is AIG. The acute liquidity crunch, triggered by AIG's credit rating downgrade that ultimately led to AIG's bailout, is attributable to AIG's failure to assess the risks of MBS, CDOs and other mortgage market exposures. Apparently, AIG relied excessively on a credit risk model that did not adequately account for both the sharp decline in the mortgage market and a downgrade of AIG's credit rating.[7]

5.3 Trading strategies

The self-assessment for investment firms shows that external credit ratings are used for certain trading strategies. Almost 27% of the responding firms who use ratings indicate to have incorporated ratings into their trading strategy e.g. an algo trader that has incorporated a news ticker in their strategy. From one of the interviews with a proprietary trader it became clear that rating information can be used as input for algorithmic trading as well.

[6] *Please see http://www.risk.net/digital_assets/4143/risk_0312_mercurio2.pdf*

[7] *Please refer to www.isda.org/c_and_a/pdf/ISDA-AIGandCDS.pdf*

5.4 Market entrance and listing

If an issuer would like to refer to a rating in its prospectus, it is compulsory to receive a credit rating from one of the registered CRAs in the EU before issuing shares to the public with an initial public offering. There is no requirement to make use of a rating when issuing bonds but using them is still common practice to let a third party review the information from the issuer. The most recent CRA Regulation even made the use of two CRAs compulsory when soliciting a rating for structured finance instruments.

Furthermore, NYSE Euronext uses rating references in its rules for the admission to listing. Euronext may require that the corporate bonds are rated by a CRA as a condition to admission to listing.[8]

5.5 Incentive for securitisation

There are two incentives for banks to securitise their assets. First central banks take into account the rating of a securitisation to determine if it can give a special advance to a bank in exchange for collateral. Secondly, due to both the possibility of a special advance from the central bank but also as an additional financing source on the capital market, banks securitise their assets. Assets on a balance sheet have no rating on their own, but asset backed securities do, even if they are still on-balance. ABS could therefore provide additional liquidity, for which ratings are necessary. An additional reason for securitisation might be more risk driven. When banks would like to reduce their exposure on risky assets, a special purpose vehicle (SPV) can remove those assets from their balance sheet.

5.6 ECB triple-A yield curve

The European Central Bank publishes daily at 12h its AAA-rated euro area central government bonds yield curve. This is a term structure of interest rates based on the ratings from Fitch. This curve can be used for instance by insurance companies to determine their risk free rate.

5.7 Example: sovereign rating influence on financials

A more indirect way of rating influence is the change of a rating that triggers the change of another entities' rating. The best known effect is the downgrade of a sovereign rating leading to the downgrade of a financial institution directly linked to the government. In the Netherlands BNG Bank is such a specialised financial institution for the public sector. S&P's explains in its research report: "under our criteria for rating government-related entities, with all other factors remaining the same, we would lower the long-term counterparty credit rating on BNG by one notch if we were to lower the sovereign rating by one notch."

[8] *Euronext Rulebook 6703/3.*

5.8 Audit and accounting

There are multiple ways how an accountant touches upon ratings during the audit. To determine the continuity of a company, one factor to be taken into account could be a cross check with the long term rating including the rating outlook. When validating financial reporting, the accountant could check whether companies have used third-party experts (e.g. CRAs) for the valuation of their (government) bonds. The auditor checks i.a. the rating of accounts receivable and the risk on outstanding loans in financial fixed assets. Lastly, the auditor keeps an eye on the solvency ratio of a company, taking into account the rating as well to determine whether the valuation of loans is properly done.

6 New legislation relevant for users of ratings

In addition to this study towards the use of ratings by market participants, new legislation came into force in 2013. In the so called CRA-3 Regulation (462/2013/EU), not only CRAs are placed under more supervision but also other market participants such as investors and issuers. Below a quick overview of the new legislative requirements for market participants that need to be fulfilled.

6.1 Over-reliance on credit ratings by financial institutions (Article 5a)

Credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument.

6.2 Information on structured finance instruments (Article 8b)

The issuer, the originator and the sponsor of a structured finance instrument established in the Union shall, on the website to be set up by ESMA, jointly publish information on the credit quality and performance of the underlying assets of the structured finance instrument, the structure of the securitisation transaction, the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.

6.3 Double credit rating of structured finance instruments (Article 8c)

Where an issuer or a related third party intends to solicit a credit rating of a structured finance instrument, it shall appoint at least two credit rating agencies to provide credit ratings independently of each other.

6.4 Use of multiple credit rating agencies (Article 8d)

Where an issuer or a related third party intends to appoint at least two credit rating agencies for the credit rating of the same issuance or entity, the issuer or a related third party shall consider appointing at least one credit rating agency with no more than 10 % of the total market share, which can be evaluated by the issuer or a related third party as capable of rating the relevant issuance or entity, provided that, based on a list to be designed by ESMA, there is a credit rating agency available for rating the specific issuance or entity. Where the issuer or a related third party does not appoint at least one credit rating agency with no more than 10 % of the total market share, this shall be documented.

7 Conclusion

Our goal was to gain some insight into the use of credit ratings in the Dutch market. We have spoken to several market participants in the different categories mentioned in Annex 1. In addition, questionnaires were sent to consumers/retail investors (Annex 2), investment firms and collective investment schemes (Annex 3).

Our general conclusion both from interviews and other sources is that the use of ratings is still widespread but seldom the only source for investment decision making. As a general rule we could say that the smaller (in terms of resources or staff) the market participant, the higher the degree of reliance on 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 both banks, CCPs and other financial institutions show that ratings still play a role, but not a decisive one. Only in a few instances, ratings mark a firm line between what is allowed and what not.

Firstly, in contracts between an investor, both institutional and retail, and an asset manager, ratings are used to determine the bandwidth for investments. These references to ratings could limit the number of investment opportunities for market participants. However, most interviewed market participants on the sell side reacted by stating that heavy cliff effects (e.g. a fire sale of assets) due to mandatory sales by the asset manager, are rare if a company or instrument gets downgraded. Grace periods or moves into a different fund can avoid those massive sales of downgraded instruments.[9] For ETFs, there is a more direct link to rating changes but with a delay as rebalancing takes place e.g. once a month or if the removal from a fund is dependent on more than one downgrading CRAs.

Secondly, the rating of the eligible counterparty is decisive for being able to use the counterparty. Especially in the inter-banking market, a change in ratings could lead to a shift of eligible counterparties. The use of a credit rating limit for eligible counterparties is mostly internal policy of the market participants without any obligation from external rules or regulation.

This survey gives a broad picture of the use of credit ratings in the Netherlands. In this exploratory study, we strived for an overview of the use of ratings in the Netherlands that is as complete as possible. However, other uses of credit ratings might be possible. In addition, although some market participants gave an indication of which CRAs are more important, we have not taken this or their performance into account in this study. Broadly speaking, the (institutional) investors and market participants interviewed mostly use credit ratings from the larger CRAs.

This survey shows that there is still a widespread use of external credit ratings but it does not lead to the conclusion that (financial) institutions rely on credit ratings on a too large scale when making investment decisions. Additionally, this survey was useful to address the role of the AFM in article 5a of the CRA-3 Regulation (462/2013/EU) and to prepare us for review of the Regulation.

[9] *Exceptional market circumstances not being taken into account.*

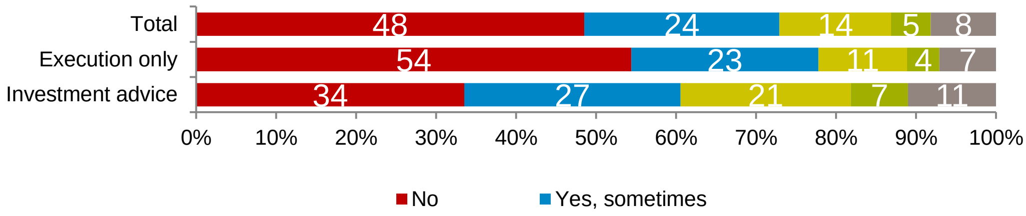
Annex 1: Preliminary overview of the users of ratings and the purpose why ratings are used

Use of credit ratings	Raising money	Benchmark	Financing costs	Creditworthiness	Counterparty risk	Investment decision	Advice	Mandate	Capital requirements	Collateral	Haircuts	Capital surplus	Market entrance	Legislation
Issuers/originators	x	x	x										x	
Lenders			x	x	x						x			
Banks			x	x	x	x	x		x	x	x			
Central clearing parties (CCPs)				x						x	x		x	
Clearing members				x						x	x			
Investors/traders		x	x	x	x	x		x						
Investment firms		x		x	x	x	x	x						
Pension investors / pension funds		x		x	x	x		x						
(credit)Insurers		x		x	x	x		x	x					
Auditors				x	x		x							
Exchange or trading platform													x	
ECB		x		x						x	x	x		x
Central banks/prudential supervisor				x						x	x	x		x
Securities regulators														x
ESMA														x
Retail investors/consumers		x		x		x								
Central government	x		x	x						x		x		x
Local government	x		x	x		x		x		x				
State Treasury Agency, Ministry of Finance	x		x	x	x	x				x		x		

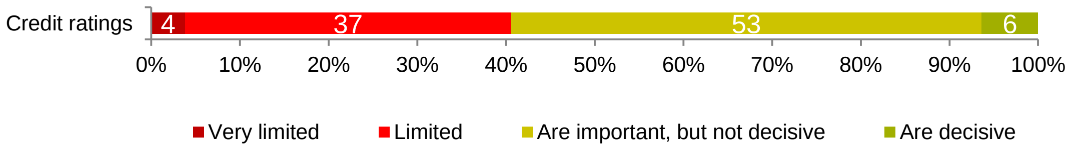
Annex 2: Charts from the AFM study towards the behaviour of consumers/retail investors in the so called 'consumer monitor'

The AFM sends out a questionnaire to a large number of consumers on bi-yearly bases. In the fall 2013 edition of this questionnaire the focus group were retail investors (n=681). The answers to the three questions regarding the use of ratings by consumers are set out below.

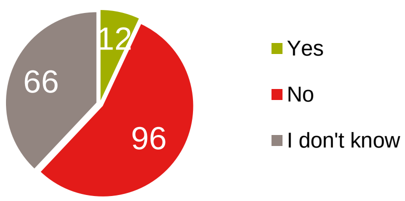
Do you take credit ratings into consideration with the decision to buy or sell investments?
Population: Retail investors that invest independently or with an advisor (n=507)



To what extent do you take credit ratings into account with your investment decisions?
Population: Retail investors taking credit ratings into consideration for a buy or sell decision (n=220)



Are credit ratings part of the agreement with your asset manager?
Population: Retail investors that invest with help from an investment manager (n=174)



Annex 3: Charts from the AFM study towards the behaviour of investor firms and collective investment schemes

Self-assessment for investment firms (2012)

The AFM methodology to supervise investment firms is risk based. In order to do the risk assessment, information is needed from the investment firms on a variety of topics. The topics differ from basic information on business operation model and key figures such as the number of employees and revenues, to more in-depth questions on conduct matters like best execution. A self-assessment for investment firms is held every other year.

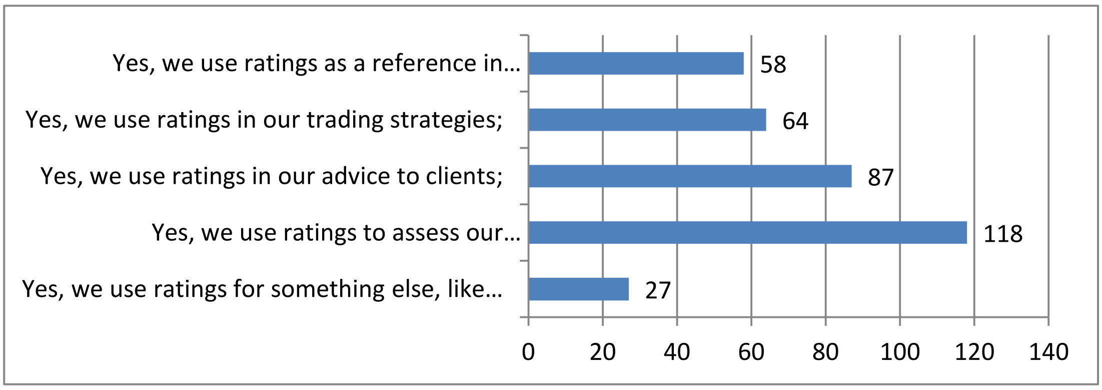
In 2012 the AFM took the opportunity to include some basic questions on the use of ratings:

1) Do you use ratings in your operations?
   a. No, we do not use ratings;
   b. Yes, we use ratings as a reference in mandates for client portfolio's;
   c. Yes, we use ratings in our trading strategies;
   d. Yes, we use ratings in our advice to clients;
   e. Yes, we use ratings to assess our counterparty risk;
   f. Yes, we use ratings for something else, like…
2) If you use ratings for references in mandates for client portfolios, please indicate what percentage of your client contracts or mandates have a direct referral to a rating level.

The results

In 2012 the AFM sent its self-assessment to 258 registered investment firms. Of the 241 respondents, 69 investment firms indicated they do not use ratings at all.

Of the 172 investment firms that do use ratings, the results[10] are shown in the figure below:

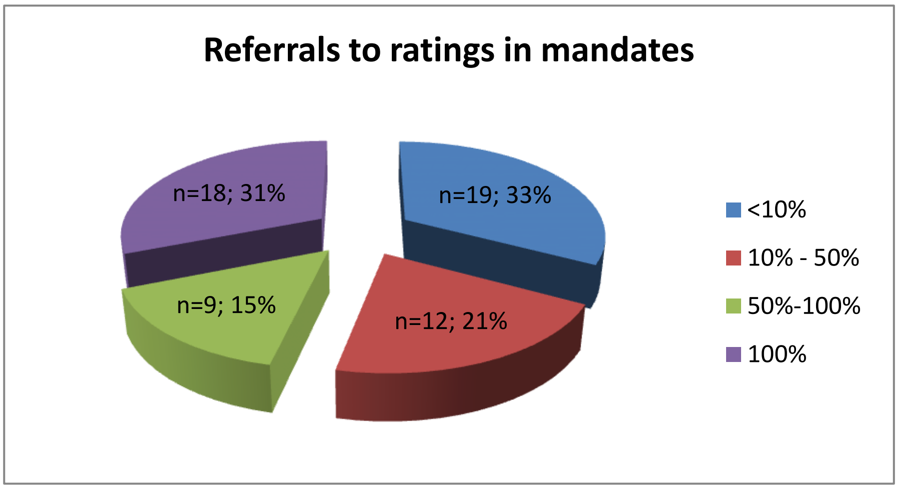


10 Multiple answers per investment firm are possible.

The main reasons given by the Investment Firms if their answer is they use ratings for something else, are:

- Model – and reference portfolio's;
- Internal investment policies and/or product selection (e.g. obligations);
- Diversity of information purposes on e.g. macroeconomics.

From the 58 investment firms who indicated to have direct referrals to ratings in their mandates of client portfolio's, more than 30% (18) have included ratings in all their contracts. In this population of 58 firms, on average, 60% of their managed contracts contain referrals to ratings.



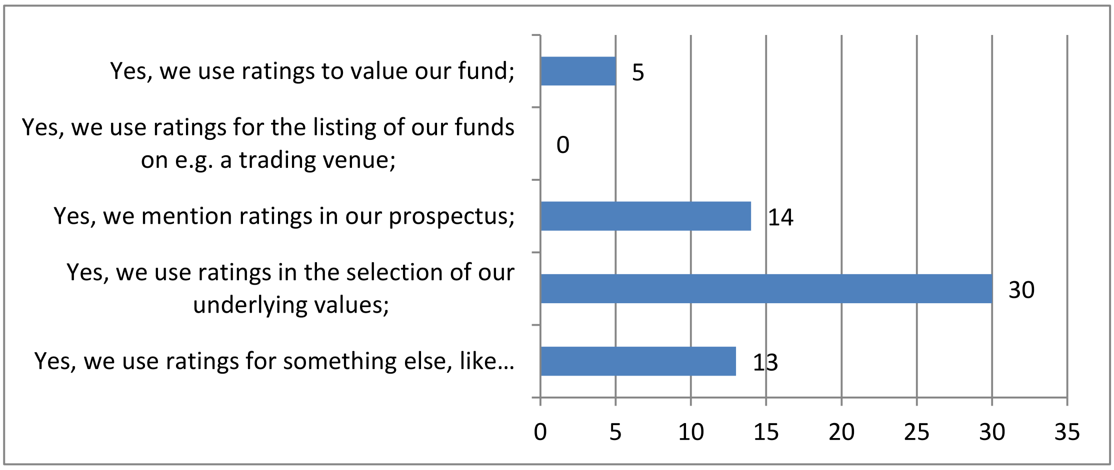
Self-assessment for collective investment schemes (2013)

In 2013 the AFM set out a self-assessment for 108 collective investment schemes with the same goal as the self-assessment for investment firms. Questions regarding the use of ratings were included in this assessment:

1) Do you use ratings in your operations?
    a. No, we do not use ratings;
    b. Yes, we use ratings to value our fund;
    c. Yes, we use ratings for the listing of our funds on e.g. a trading venue;
    d. Yes, we use ratings in our prospectus;
    e. Yes, we use ratings in the selection of our underlying values;
    f. Yes, we use ratings for something else, like…

The results

36 of the 108 collective investment schemes indicate they use ratings in their business model. In the figure below is set out to which purpose they use ratings[11].



The main reasons given by the collective investment schemes, if their answer is they use ratings for something else, are:

- Selection of counterparties, for example:
    - when involved in OTC trades (assessing counterparty risk);
    - Selection of banks for the safekeeping of the mandatory liquidity requirements;
    - Creditworthiness check on tenants (asset management)
- (Monthly) reports to clients to inform them on the diversity of the investment portfolio;

[11] *Multiple answers per collective investment scheme are possible.*

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