The Netherlands CRA Action Plan – Supplement to the EU Action Plan

The Netherlands is committed to the agreements made on a global and European level to reduce the sole and mechanistic reliance on ratings. Therefore at European level we will follow the route set out in CRA3, which envisions the deletion of all references to credit ratings in Union Law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risks have been identified and implemented. This is in line with the goals set out and confirmed at the G20 summits. The initiatives taken by FSB in order to find those alternatives on a global level and to bring them under the attention of national competent authorities and financial market players are very useful to further this process in a positive manner.

1. LEGISLATION

1.1 Dutch financial law

References to external ratings in Dutch financial law stem mainly from obligations derived from European directives. Following initiatives taken and agreements made on European level, the references causing sole and mechanistic reliance are expected to be deleted under new and upcoming European Directives and regulations (incl CRD IV and Solvency II). This will subsequently lead to the transposition in Dutch financial law, deleting or replacing those references as a consequence. Other references to ratings – that not directly follow from European regulation - are not widespread throughout the Dutch Act on Financial Supervision (*Wet op het financieel toezicht, Wft*). Moreover, in that case, many of these references do not prescribe the sole and mechanistic use of ratings. They only describe under which circumstances ratings could be used by a financial institutions if it desires to do so.

As of the 1st of January 2014 the 'ministerial regulation theoretical solvency criterium for life insurance companies' contains a reference to ratings in calculating the Theoretical Solvency Criterium (TSC). Life insurers that have to comply with Solvency II (when this directive comes into force) are obliged to calculate the TSC. This reference will be deleted once Solvency II comes into force.

We would like to remark that apart from financial law, there are laws governing non financials, including (semi) public institutions that could contain references to ratings.

1.2 National Supervisory Rules containing references withdrawn

The *Capital Requirements Directive IV* (directive nr. 2013/36/EU), hereafter referred to as CRD IV, and the *Capital Requirements Regulation (regulation 575/2013/EU),* hereafter referred to as CRR both have effect on the DNB supervisory rules (in Dutch: toezichthouderregelingen).

Since the CRR has direct application and transformation in national law is not allowed, the majority of DNB's supervisory rules are withdrawn as from 1/1/2014. These supervisory rules consisted mainly of the requirements stemming from the Annexes in the current CRD/ CAD. Since these requirements will

be covered by CRR, national rules are no longer allowed nor needed. The following supervisory rules (and with those the national references to credit ratings) are withdrawn:

- Supervisory Rule on solvency requirements credit risk and large exposures Wft 2010
- Supervisory Rule on solvency requirements market risk Wft 2010
- Supervisory Rule on solvency requirements operational risk Wft 2010
- Supervisory Rule hybrid instruments banks and other financial institutions (excluding insurers) Wft 2010;
- Supervisory Rule on securitizations Wft 2010
- Supervisory Rule exclusion solvency deductions immaterial assets

At a lower level, some regulation (although these rules are technically not binding to institution, rather than internal guidance for DNB) still maintain some references to credit ratings (in the so called Policy Rules). However, we expect that the majority of these references will be withdrawn as EBA's work on draft regulatory and implementing standard moves forward. Any remaining references will not imply a sole and mechanistic use of external ratings, but will be a first reference that needs to be supported by further analysis.

2. ACTIVITIES BY THE DUTCH FINANCIAL SECTOR SUPERVISORS

The financial sector supervisors (*De Nederlandsche Bank* and *The Netherlands Authority for the Financial Markets*) will also primarily follow the European route and support and contribute to the work in the EBA, EIOPA and ESMA working groups. In addition, initiatives in the supervisory approach are aimed at further reducing the reliance on external ratings

2.1 Thematic supervision: increasing risk management and risk awareness

In supervisory activities of *De Nederlandsche Bank* (DNB) it uses thematic supervision of which an important aspect is that financial institutions need to assess and understand its own risks. This means that in the day to day supervision DNB expects financial institutions not to solely rely on external risk assessments.

In addition, an important aspect in the supervisory strategy of DNB, is to assess the culture and governance within an institution as main risk driver of financial sound business model. This also incorporates a judgment on the way risk governance within the financial institution is organized and the extent to which the institution relies on external risk assessments.

Also in *Focus!,* the supervision strategy of DNB, there are several risk drivers identified of which culture and governance are important aspects. This therefore also incorporates a judgment on the way risk governance within the financial institution is organized and subsequently a judgment on the extent the institution relies on external risk assessments.

2.2 Role of external ratings in determining risk weighted assets

Within the context of the Basel framework, banks can use the standard approach or the internal model approach for calculating risk weighted assets, which subsequently determine capital levels.

Within the internal models, external ratings don't play a formal role. Moreover, DNB has a supervisory responsibility with regard to the use of internal models. Before Dutch banks can make use of internal models, or in case these banks want to make significant modifications to these models, this needs to be validated and approved by the Dutch supervisor (DNB). Large and medium sized Dutch banks all make use of internal models for the largest part of their total exposures. The use of internal models for calculating risk weighted assets currently accounts for more than three quarters of the total exposures of the Dutch banking sector, although Dutch banks may use external ratings as a benchmark for their own internal analysis.

Within the standard model there is a limited application of external ratings in the classification for certain asset classes. This is expected to be further reduced since in CRA3 agreements are made to reduce the sole and mechanistic reliance on ratings in regulation by 1 January 2020, provided that appropriate alternatives to credit risks have been identified and implemented. Also, credit rating agencies need to comply with European rules to safeguard the quality of ratings, increase transparency and prevent conflict of interests. However only, a number of mainly small Dutch banks apply the standard model for determining risk weighted assets. The amount of banking assets for which the risk weighted assets are determined directly by external ratings amounts to less than 10% of the total.

The Basel Comittee is currently, as part of the review of the standard model, looking into ways to reduce the reliance on those external ratings. To conclude, the direct role of ratings in determining the risk weighted assets of Dutch banks is relatively limited, and expected to decrease further in future.

2.3 References in mandate contracts of institutional investors

The Netherlands Authority for the Financial Markets (AFM) is currently looking into the Dutch market's use of ratings including references in the mandate contracts of institutional investors. This will be matched with the stock-taking exercise of other European national competent authorities and give an overview to which extent institutional investors in European countries rely on ratings. This action is done to give an advice to the European Commission whether additional European measures might be necessary if these references cause sole and mechanistic reliance on ratings.

3. CONCLUDING REMARKS

Dutch financial law and Supervisory Rules do not include many references to ratings. Most of the references that are included are derived from European rules which have been transposed into Dutch rules. The Netherlands is following the European route there where it comes to reducing the sole and mechanistic reliance on ratings, also where it comes to input from the supervisory bodies DNB and AFM in EBA, EIOPA and ESMA working groups. Apart from that, DNB also encourages in its supervisory activities a sound risk management framework and culture within financial institutions to assess and understand their own risk position and not to rely solely and mechanistically on external ratings. A

substantial part of existing references in supervisory rules have been deleted as of the 1st of January 2014, as the rules themselves have been deleted. References in Union Law will be deleted and/or replaced by reliable alternatives if available, as the regulatory work of the European Commission and the European Supervisory Authorities moves forward. The FSB initiatives to find alternatives to ratings are welcomed by the Netherlands. Furthermore, the Netherlands has confidence that the supervision of ESMA on credit rating agencies strengthens the quality of ratings.