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By Electronic Mail

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**SUBMISSION ON APRA DISCUSSION PAPER ON MARGINING AND RISK MITIGATION FOR NON-CENTRALLY CLEARED DERIVATIVES (“DISCUSSION PAPER”)**

Moody's Investors Service (MIS) wishes to thank the Australian Prudential Regulation Authority (APRA) for the opportunity to comment on the Discussion Paper and the draft *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (“CPS 226”). We focus our comment on the proposed set of eligible collateral for margining purposes as discussed under Section 5.1 Eligible collateral of the Discussion Paper and in paragraph 46 of CPS 226.

Section 5.1 of the Discussion Paper sets out APRA's rationale in determining the list of eligible collateral permitted, which is to balance the ability of the collateral assets to hold value and be readily liquidated in a period of stress against the additional costs of limiting eligible collateral to only the most high quality liquid assets. CPS 226 sets out the list of eligible collateral margin, including among others, debt securities rated by an external credit assessment institution (ECAI) with certain credit rating grades according to the different types of issuers as set out under paragraph 46 (b) to (f). As such, the eligibility of certain debt securities as margin as proposed in CPS 226 is linked to their credit ratings.

MIS supports the broader efforts to reduce financial system instability from the risks of inadequate collateralisation of non-centrally cleared derivatives. However, using credit ratings issued by ECAs as

the primary criteria for the eligibility of debt securities may inadvertently amplify rather than diminish risks in the system. We will discuss our concerns in more detail below.

## **1. Mechanistic use of ratings in regulation**

In its Principles to Reduce Reliance on Credit Ratings<sup>1</sup>, the Financial Stability Board states under Principle I that:

*Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards or creditworthiness.*

MIS is concerned about the mechanistic use of ratings in regulations proposed in CPS 226. Adopting ratings-based eligibility criteria for debt securities could lead to a regulated entity disposing of the collateral if the rating drops below the required eligible threshold. This may trigger a “cliff effect” where counterparties are required to replace the collateral with securities that satisfy the ratings requirement which could exacerbate market volatility in times of financial distress<sup>2</sup>.

## **2. Credit ratings should not be used to measure any risk other than credit risk**

MIS credit ratings reflect our current opinions of the relative future credit risk of entities and their debt obligations. They do not measure any other risk, and should not be used as a proxy for assessing other characteristics of a security, such as liquidity risk, price volatility or marketability.

### **Alternative approaches**

If credit ratings as an eligibility criteria is retained by APRA, to avoid potentially triggering market significant events when ratings change, MIS suggests reducing the impact of ongoing ratings-based requirements for qualifying collateral so that individual rating changes are less likely to have market-moving effects e.g. introducing appropriate concentration limits and a ‘grace period’ to allow counterparties time to replace the collateral if a rating downgrade leads to its non-eligibility.

Another alternative is to permit counterparties to use a range of assessment factors (which may include credit ratings for credit risk) when determining the credit quality and liquidity of the collateral instead of relying solely on external ratings for eligibility.

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<sup>1</sup> The FSB’s Principles for Reducing Reliance on CRA Ratings (October 2010) is available at [http://www.financialstabilityboard.org/wp-content/uploads/r\\_101027.pdf?page\\_moved=1](http://www.financialstabilityboard.org/wp-content/uploads/r_101027.pdf?page_moved=1)

<sup>2</sup> We have noted the proposed collateral haircuts in CPS 226 which may serve to mitigate the risk of potential falls in the collateral value during financial stress.

In our view, by using various types of assessments in determining the eligibility of the debt securities as collateral, it would allow for discretion at both the regulatory level and counterparty level, mitigating the risk of an individual opinion or measure in causing excessive market reaction.

Please do not hesitate to contact me with any queries.

Yours sincerely

A handwritten signature in cursive script that reads "Natalie Wells".

**Natalie Wells**  
**Country Manager**