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COFACE RESPONSE TO THE CEBS CONSULTATION PAPER ON THE RECOGNITION OF EXTERNAL CREDIT ASSESSMENT INSTITUTIONS

Introduction

The Committee of European Banking Supervisors ("CEBS") has just published a Consultation Paper on the recognition of External Credit Assessment Institutions ("ECAI"). Coface is a leading player in credit management services, notably business information services, and could be an applicant to the ECAI status. Here is our comment paper.

The CEBS Paper is clear and precise and we support most of its terms. We support the recognition process as stated, notably the joint process for recognition which appears to us a cost-efficient way to proceed, whilst enhancing the harmonization of risk assessment at EU level. The request for transparency in rating methodologies is a good thing. Coface also welcomes the strong emphasis put by CEBS on data quality and methodology.

The recognition of the importance of efficient external providers of information to the credit market is a huge progress allowed by the new Basle II regulation. Its primary goal is to increase financial stability by creating strong incentives for banks to assess more accurately their risks. In this respect, ECAIs are important players in the system because they bring qualified information to risk-taking parties; they help to reduce information asymmetries between lenders and borrowers, and they limit potential propagation of financial shocks in the economy. It is now well documented that there are situations where banks may "optimally" decide to limit the screening of borrowers, or situations where information is too scattered between lenders to be of much use for risk taking. Here professional collectors of relevant credit information have a tantamount role.

In our view, their importance exceeds their simple role as an information supplier for banks in the Standard approach as set by the new regulation (with the status of ECAIs). They clearly contribute to financial system stability by helping <u>all</u> corporates <u>and all</u> banks, including the ones electing the IRB approach, to better assess their risks. They have a long history of data collection and credit ratings, both across sectors and across countries, that help create a homogenous evaluation of risks. They provide alternative visions of specific risks and benchmarks for banks, as banks' portfolios do not necessarily cover all the economy nor a long time span of data. Banks may use ECAIs ratings as an input in their internal rating systems. Also, as stated by art. 137 of the Consultation Paper, some inputs from ECAIs are needed to define the monitoring and trigger levels of defaults.

ECAIs also play a role in opening credit markets and increasing their level of competitiveness. Many small firms are limited in their access to credit, and banks often "capture" these firms simply because other parties lack publicly available credit assessment. The presence of efficient information providers in the credit market may in this context help competition and small firms' access to credit.

Therefore, both ECAIs and banks opting for internal methods are complementary and the promotion of ECAIs is not contradictory to banks being more and more self-supportive in assessing their risks. This is why we highlight to regulatory bodies the importance of building up a competitive industry in independent risk assessment. This is clearly supported by the granting of the ECAI status.

If the Basle II regulation is going in the right direction, we insist that the promotion of ECAIs should be one of its major focuses. In our opinion, the Consultation Paper appears in some areas too restrictive.

For instance, the requirements stated by the Consultation Paper, that ECAIs should have a strong market acceptance (see art. 71) can be seen as limitative as it represents a premium to incumbent credit assessment entities. Also the requirement put to the would-be ECAI to be accompanied by a bank which intends to use its ratings in the Standard approach before ECAI eligibility, is some kind of barrier to entry. We think that the evaluation by regulatory authorities is a better means of selection than existing market recognition, since the market is nascent (save for the activity of listed securities ratings).

We welcome the idea of establishing a mapping that will help to create a homogenous rating scale. Nevertheless, one should keep in mind the strong heterogeneity across markets and countries, and even within markets, in terms of rating methodologies, defaults experience and, most of all, default definitions. Therefore, we think it is not appropriate to have a unique mapping, independent of default definition and of the market considered.

For instance, the mapping of Annex 2 to the CRD paper does not seem appropriate for the SME credit market, especially in the frame of the joint process recognition. Most of agencies' ratings systems for SME are calibrated on legal bankruptcy. Yet, it is well known that the definition of bankruptcy differs from one country to another one, so that default rates are very different. From our experience, default rates are rather similar in France and Germany, where bankruptcy rules put similar constraints on firms, but different in Spain and Italy, where bankruptcy law do not play the same disciplining role. Our suggestion is that the CEBS should provide either a mapping which takes into account these differences between countries or a mapping for each country.

In addition, the proposed mapping process is calibrated on the probabilities of default given by large ratings agencies. This method is not entirely convincing for SME loans. Appendix 1 to this document presents a detailed argumentation based on French data, which can be a basis for improvement.

Answers to the questions

Question 1: If you are an institution or an ECAI, how do you envisage using the proposed recognition process, in particular in cases where applications for the same ECAI are submitted in more than one Member State at the same time?

1) We agree with the proposed implementation of the joint process, as it will reduce administrative burdens and help create a harmonised playing field across countries.

However, we stress the importance of having a process that takes into account specificities of each country.

This means that the criteria that will be elected in the joint process should not impose conditions in a way that prevents the integration of countries' specificities, typically differences in default definitions.

We would like to know what weighting, in examining the application form of an ECAI, the joint process will give to institutions evidencing cross-country rating experience, since it complements a lack of across-time experience in a single country.

Moreover, there are countries which, because of the lack of rating culture, do not record data on defaults. Thus, if the joint assessment puts the same weight on all requirements whatever the country, this will refrain the emergence of rating companies.

2) We recommend that the regulation does not erect "regulatory" barriers to entry. But as the goal is also to have competent ECAIs, CEBS could impose to any applicant on a country with no sufficient data history to show a strong expertise on a "well developed" market (i.e. with a rating culture, data collection, …).

Therefore, the evaluation process could be more "global" rather than just local; it could build a joint assessment process for the ECAI on each well-developed market in terms of rating culture etc., and then evaluate the applicant ECAI on all its markets treated as a whole.

In countries where no unique definition of default prevails, credit information providers may help promoting a definition of default consistent with the one generally accepted in other countries. This is why endorsement of ECAIs regulatory authorities may be positive.

3) The requirement that the future ECAI has at the date of submission at least one bank that uses, or intends to use, its rating appears to us dangerous. If on a certain market, no bank intends to use the Standard approach, then the requirement clearly eliminate the emergence of an ECAI. Although its presence may appear irrelevant if no bank has any use for it, the market for ratings should be considered differently. Why imposing on any newcomer in a market to have existing clients. If for example there is only one bank which intends to use a standard approach, and that several firms fulfil all other requirements to become ECAIs, how can it be that each ECAI should have at least a bank which intends to use its ratings? Will it result in some sort of bribing of the sponsorship of that bank?

In our view, this constraint overlooks the importance for banks that elect internal methods of having side-to-side, professional suppliers of information. This request could possibly be replaced by the requirement that the ratings of the applicant ECAI be used by other firms for risk management or by banks (but not necessarily in the Standard approach).

Question 2: Do you support the proposed joint assessment process? Does it address the need for efficiency, consistency and reduced administrative burdens in light of the CRD requirement that each competent authority makes its own decision (direct or indirect) on eligibility?

1) Our comment is that the regulation should endeavour to extend the role of ECAIs, and recognise their role in helping banks to assess credit risk, whatever their rating approach. In all countries, banks will need benchmarks or information they do not have.

For example:

- Some ECAIs have precise information on financial links between firms, and are able to integrate it in a rating model, and banks do not have the information precisely,
- Some ECAIs have investigators that collect valuable information that banks cannot have,
- ECAIs may have information on financial links, soft information coming from inquiries, etc.
- Some little banks don’t have sufficiently large population of risks to produce statistics
- Some banks, developing a subsidiary in a foreign country, will need benchmarks to assess their internal rating.

2) It would be helpful and cost saving that the supervisory body in all countries that expects receiving an ECAI application publishes its specific set of requirements, potentially different from the joint assessment process. The joint process should thus be restricted to "objective" criteria and be more than just some guidance for national authorities.

3) For an applicant ECAI which has many subsidiaries, we think there should be an intermediary level between recognition at group level and one at subsidiary level. If a group demonstrates that its methodology satisfies all the requirements of the recognition process in most subsidiaries, but is only in a process of being compliant in the rest of its subsidiaries, then we think a recognition process should be started with these subsidiaries. Said differently, the overall group expertise should be taken into account when dealing with a specific local entity, provided the same processes and methodology is applied,.

Question 3: What are your views on the proposed common understanding of the CRD recognition criteria to be implemented by supervisors in determining the eligibility of ECAIs?

1) The "favourable opinion of the market" that CEBS intends to take into account should be interpreted widely. In particular, the market does not only mean banks or investors, but also incorporates non financial firms and other institutions. Reputation should be based on a wide definition of the market, because each ECAI has its own market which may be different from one another. To be noted that this requirement gives a premium to incumbent players.

2) The supervisor should take into account that some applicants have experience and know-how in markets where existing rating agencies have little history. This is the case typically in the SME market. Thus it seems natural not to base all the benchmarking on existing rating agencies.

3) No reference in the text is made on the need to have a sufficiently exhaustive and high quality database. No reference on soft information is made either, an area where potential ECAIs have a strong experience that can be complementary to banks' information. Indeed, the quality of the data and of their management (updates, checking, quality management procedures, etc. …) is a key factor of reliability of any rating system.

4) The decomposition into three markets (commercial market, public finance and securitisation market) is not sufficient. In a given market, it is possible to have different methodologies because of data problems. For example, one cannot have the same methodology to rate big and very small firms. The latter require a huge and high quality database. It also requires expertise in dealing with such firms. When assessing a potential ECAI, the regulatory authority should take into account the history an applicant has in each relevant market. No reference to knowledge of a market is made and in particular the CEBS document does not mention the fact that applicants do have today practical experience in different fields that can give them some extra-expertise in the rating activity. So one should take into account not only data, methodology and so on, but also the human factor and the knowledge an applicant may have thanks to its main activities. There are qualitative factors which cannot be integrated easily in a quantitative model but are of primary importance for assessing the risk of a company.

Question 4: What are your views on the proposed approach for implementing the mapping process?

1) For reasons explained above, we advise to refrain systematic benchmarking for mapping purposes on existing recognised rating agencies. Some other agencies may have more experience in some specific markets.

2) We would like to understand exactly what the CEBS means about the reference made to the methodologies of existing agencies in article 142 of the consultation paper? The diversity of ECAI applicants reflects the diversity of the market.

3) The requirement of having 10 to 13 years of default data is too strong. We acknowledge it comes from the necessity to have sufficient default data, especially facing the assessment of ratings systems dedicated to very limited populations. In this case, it is an obligation to use very long-term default rates to compensate the very low depth of the rated samples. Nevertheless, in some markets like the SME one for example; defaults are numerous enough each year to allow statistical treatment. Thus a combination of a more precise assessment of the methodology and a shorter period of defaults seems more reasonable. There are countries where no rating culture exists and consequently 13 years of default definition is simply impossible.

4) In some markets, conditionally on the default definition, it is not necessary to refer to historical data of existing rating agencies since there exist public company registrars that can give historical default rates.

5) The mapping of annex 2 of CRD paper is not appropriate for SMEs' market. The supervisor should provide either a mapping which takes into account differences between markets or a mapping for each big market. Appendix 1 hereafter explains our arguments with a precise calculation on French data. It argues that it is very unlikely that one mapping is appropriate for all markets in all countries. The main reasons are that definitions of default are very heterogeneous in European countries, and that track records of SME ratings are not available in all European countries.

6) It is also very unlikely that one single mapping fits for all markets and for all countries. Moreover, there is no history of ratings of SMEs in all countries, and the mapping done with the CDR (Cumulative Default Rate) of rating agencies will not include data on SMEs. Consequently, it is hard to understand how the CEBS will give a mapping for this market. We propose that the CEBS Paper asks potential ECAIs for mapping proposals and then defines a benchmark on these proposals.

7) Default definition: One should emphasise two important points on default definition:

- It is not only default definition that matters in a Basle II context since two parameters enter, PD (probability of default) and LGD (loss given default). These two parameters are linked: the more severe default definition is (and thus the lower is PD), the higher is LGD. Consequently, if we impose mappings on PDs, one should also provide some ideas of what LGDs are. What matters is the combination of the two parameters. This allows some latitude in default definition (to take into account country specificities) and also mapping.

- We propose, based on our experience of credit evaluation in many countries, to ask for proposals of default definitions by country and mappings for sub-markets (SMEs for example).

Question 5: Do you support the proposal that the mapping of credit assessments to risk weights should also be addressed under the joint process set out in part 1 for applications made in more than one member state?

It seems hard, given all our remarks on country specificities in terms of default definition and data availability, to integrate the mapping into a joint process. The mapping should instead be addressed at each country level to take into account these specificities and it should be built in association with ECAI applicants. What the joint process could bring is rather a "methodology" to facilitate the mapping building process.

Question 6: Do you think that the concept of loss rather than default probability alone is the appropriate key parameter for mapping securitisation credit assessments? If not what should be the appropriate parameter?

As argued above, the concept of default probability is not the only parameter to take into account whatever the market considered. There is not a huge difference between a security built on lines of credit for SMEs and a security issued by a corporate. This is why we emphasize the fact that different approaches on equivalent given risks can create arbitrage opportunities.
Indeed, one can see a securitized portfolio of credit exposures as the exact replication of an on-balance sheet portfolio if the structuration presents no default reserves, first loss, cash reserve or other securities. In this case, it is important to notice that the losses approach is a

very economics-driven approach compared to pure default probability method. This will allow arbitrage driven transactions if this economic approach, thanks to securitization, relieves regulatory capital compared to holding an in-balance sheet portfolio. This arbitrage will rise if, for example, mappings are made on default definitions stressed relatively to the LGD used. In this case, same risks will be seen with two different sights, leading to a regulatory arbitrage. The same will rise if correlations used in a securitization (e.g. CDO) are different than the regulatory ones.

In conclusion we estimate that the losses approach has an indirect impact in term of consistency with the default probability approach since the first goes more far in the economic analysis than the latter. We estimate thus that regulators will have to be cautious on the indirect assessment that will be implicitly made on default probability methods through an assessment based on a losses approach.

Appendix 1

As the CEBS consultation paper recalls, mapping process efficiency depends of the availability of two kinds of data: actual rating assignments combined with the characteristics of rated borrowers and a history of defaults for such borrowers. If this information is available, there are two main methods of mapping: the median-borrower method and the weighted-mean-default method. Consider two different ratings systems: an "internal" rating system of a given ECAI, and the "external" ratings system of a rating agency. The first method involves, equating, in a first step, each grade of the internal system to the external ratings system grade, and, in a second step, to use the long-run average default rate for the external grade as the estimated default probability of each grade. The first stage can be done judgmentally, or mechanically, by taking the rating of the median borrower as representative of the risk associated with the grade. The second method is a variant of this median-borrower method. The probability of default of each agency-rated borrower is taken to be the long-run average historical default rate for the borrower's grade and the mean of these rates for each grade is used as the estimate of the average probability of default of the grades. In other words, the mapping process should assign the same grade to borrowers that have the same distance to default, that is, following Merton's structural approach of default, the same relationship between the borrower's amounts of debt relative to the volatility of its assets, whatever the nature of the liability.

Both mapping methods are subject to potential problems, especially if we consider SME exposures. First, for rated bond portfolios, the mapping is easy because agencies' estimated probabilities of default could be used, because the definition of default is unique and quite universal, and large corporate loans behave in the same way. For SME exposures, such statistics do not exist, even at the country level. In addition, the probabilities of default are very sensitive to the definition of default used by each rating system or in each country. Let us provide an example.

Let's build two ratings system using a large database of French SME (around 100.000 firms), a logit model, the same set of exogenous risk factors (explanatory variables such as leverage, profitability, liquidity ratio, firm's size), but two different criterions of default. The first model computes scores and probabilities of default by using legal default criterion, that is legal bankruptcy, while the second one uses bank loan default, that is 90 days past due on commercial loans. Then, we assign grades by dividing the scores interval into deciles. We get two ten grades ratings systems. As a result, we observe that a large majority of borrowers sharing a given grade (let's say grade 1) in a ratings system share the same grade (grade 1, again) in the other ratings system. In other terms, the two ratings system classify firms in the same manner, so that borrowers sharing the same grade have the same relative distance to a given form of default in the two systems. Indeed, taking a given criterion of default, for instance the legal bankruptcy default, we observe that the median or average default rates are quite close for the same grade (says, grade 1) in the two ratings scales (table 1). The same is true if we take another criterion of default.

So, the mapping seems to be a quite easy task, in a sense that it is possible to map "automatically" the two ratings systems. Nevertheless, due to the difference of default criterions, as shown in table 1, the two systems give different probabilities of default (PD), and, consequently, different absolute distances to default. The same grade gives a higher PD in the loan default model than in the legal bankruptcy model. On average, bank loan default is a more frequent event than legal bankruptcy. In addition, this exercise shows that mapping methods of quantification might produce estimates that are too pessimistic for safer grades and too optimistic for riskier grades.

Table 1: *Probabilities of default associated to each grade in two different ratings systems using different criterions of default*

	Probability of legal bankruptcy		Probability of bank loan default	
Ratings grades (deciles of scores)	*In the legal bankruptcy model grades (1)*	*In the bank loan default model grades (2)*	*In the legal bankruptcy model grades (3)*	*In the bank loan default model grades (4)*
1	0.19	0.18	2.07	1.29
2	0.60	0.59	2.61	1.80
3	0.31	0.36	3.20	2.08
4	0.71	0.67	3.90	2.80
5	0.77	1.07	4.44	3.14
6	0.69	1.07	5.15	3.93
7	0.79	1.22	4.11	5.34
8	2.00	2.00	6.31	7.41
9	3.90	4.19	8.59	7.60
10	10.61	11.99	14.79	17.99

Source: COFACE

In fact, the degree of proximity of distances to default depends on legal and institutional conditions in which creditors take their decisions to declare the insolvency of their debtors. If these conditions vary, for instance, from one country to another one, it is not easy to choose boundaries so that grades cover ranges of default probabilities that are similar in the two ratings systems. We need at least to know the effective rate of default in each country, taking a criterion of default. But, two problems appear. Firstly, in some countries, it is quite impossible to build a score by using a given criterion (says, the bankruptcy criterion), and it is necessary to use an "approximate" criterion, for which there are no consensus about the value of default rate. Secondly, the relationship between two different criterions, for instance bank default and legal default could change from one country to other ones.

Quantification bias could also come from the differences in the architecture of ratings systems. Indeed, for portfolios of small businesses loans, most of the ratings (proposed by future ECAIs) are not through-the-cycle ratings, but point-in-time ratings, similar to banks internal rating systems. The mapping method may be inappropriate because such loans behave differently than large corporate loans.

So, to resume, it is very unlikely that one mapping is appropriate for all markets in all countries. The main reasons are that definitions of default are very heterogeneous in European countries, and that histories of SME ratings are not available in all European countries. We think that a new mapping exercise is necessary in order to obtain risk weights that better reflect the SME risk. The supervisor should ask potential ECAIs for mapping experiments, in order to define benchmarks. Coface is ready to participate to this exercise.