



**Comments of the Italian Banking Association on the CEBS
proposals on recognition of the ratings of External Credit
Assessment Institutions for purposes of calculating capital
requirements against securitizations for banks using the
Standardised Approach and the Ratings Based Approach**

September 2005

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1. Introduction

On 29 July 2005 the Committee of European Banking Supervisors (CEBS) initiated a consultation procedure¹ on the recognition of the ratings of External Credit Assessment Institutions (ECAI) in calculating supervisory capital requirements on banks which – with the entry into effect of the Capital Requirement Directive² transposing the provisions of the new Basel Capital Accords of June 2004 – adopt either the Standardised or the Ratings Based Approach in securitizations.

In summary, the CEBS asks for specific comments on the following parts of the consultation paper:

- The procedure for recognizing ECAIs. The provision is that application to the competent authority for recognition of eligible ECAIs can be made by the banks, by the ECAIs themselves, or by both applicants, in one or more Member States at the same time. Recognition may be accorded either through direct assessment by the supervisory authority or through joint assessment by the authorities of the EU countries where application for recognition has been made. "Indirect" recognition of ECAIs by one country's authority is also possible, in the case that the ECAI has already been granted recognition in other Member States;
- Technical requirements for ECAIs. A series of analyses are offered on the requirements for recognition of eligible ECAIs introduced in the proposed CRD, now in the phase of approval by the European Parliament;
- Implementation of mapping. The paper sets out proposals for assigning weights to the ECAIs' ratings. Specific passages are devoted to the process of mapping some portfolios, such as short-term loans, positions deriving from securitizations and investment fund units;
- Export Credit Agencies (ECAs). The paper clarifies a series of points regarding banks' use of ECAs' ratings in calculating their supervisory capital requirement;

¹ *Consultation Paper on the recognition of External Credit Assessment Institutions.*

² Recast 2000/12/EC and 93/6/EEC Directives.

- Common Basis Application Pack.
- This is information that the applicant must submit to the supervisory authorities before the recognition procedure is initiated.

In order to work out the position of the Italian banking system on the proposals set out in the consultation paper, the Italian Banking Association conducted a coordinated, systematic survey of the points of view of its member banks. Based on the observations received and the work of several ad hoc interbank groups ABI has drafted this response, which has been approved by the Association's Executive Committee and forwarded to the Italian supervisory authorities.

The appendix sets out ABI's proposed amendments to the CRD as regards mapping and guarantees that ECAIs satisfy the credibility requirement.

2. Comments of the Italian banking industry

Italian banks appreciate the CEBS consultation initiative on recognition of eligible ECAIs in the light of the entry into force of the Capital Requirement Directive, considering the major influence that rating agencies may have in the securities and credit markets.

The set of requirements and procedures designed by the CEBS for recognition is broadly acceptable and incorporates the observations made in ABI's position paper in response to the CESR consultation procedure as well as in the Association's proposed amendments to the CRD, in particular:

- (i) Incorporation of the Basel Committee proposal on mapping. In brief, §§ 128-140, transposing those of Annex 2 to the Basel Committee document of June 2004, provide that – after several specific benchmarks relating to cumulative default rates correlated with given ratings by the main agencies have been set – then if in the long run the default rate for each rating class of an ECAI exceeds a given benchmark value, higher risk weights will be applied to assets with those ratings;
- (ii) disclosure of eligible ECAIs. Under § 58, the supervisory authorities of each Member State must release a special list of ECAIs judged eligible

for supervisory purposes (and the capital ratios applied to the "credit quality steps" of the eligible ECAIs);

- (iii) conflicts of interest. In §§ 88-92 the paper introduces a series of constraints that ECAIs must observe in order to satisfy the requirement of "independence" laid down in the CRD (and the IOSCO code); in particular, ECAIs whose shareholders include governments, professional associations or other political bodies must be free of all possible pressure for favourable ratings for institutions operating in the shareholders' sphere of influence;
- (iv) the "credibility" requirement. § 21 provides that where it is the ECAI that requests recognition of its ratings for supervisory purposes, it must demonstrate that at least one bank is intends to use its ratings in calculating its capital requirement.

These proposals ensure:

- (i) greater objectivity and reliability for ratings;
- (ii) limitation of market access exclusively to highly reliable ECAIs, thus avoiding the potential distortions that would stem from the creation of rating agencies with lesser standing, with a tendency to issue better ratings as a means of penetrating the market and for this reason less trustworthy;
- (iii) the certain identification of the ECAIs deemed eligible by the supervisory authorities;
- (iv) an incentive for new ECAIs to adapt to the best practices of the leading established rating agencies;
- (v) an incentive for constant monitoring by the agencies' of their own methodologies.

However, there are some aspects of the CEBS paper that warrant further review and revision.

First, the provision of § 11 that it is the banks that bear the ultimate responsibility for deeming the risk ratio assigned by an eligible ECAI's rating to be appropriate is utterly unacceptable. Rather, it is the task of the supervisory authority to evaluate the reliability of the ECAIs' ratings, monitor their stability and declare their validity. Once the list of eligible ECAIs is released, the bank must be considered to be authorized to use their ratings in calculating their capital requirements.

It is worth noting that banks that use external ratings to calculate their supervisory capital requirement – i.e. those that take the standardised or RBA approach - will presumably not have obtained authorization to develop their own internal rating systems. Thus they would not have sufficient data, much less the potential to verify and evaluate the eligibility of the outside ratings utilized; and these ratings in any event must be vetted by the supervisory authority.

As for the possible applicants for recognition of ECAIs for supervisory purposes (banks, the ECAIs themselves, or both), the Italian banking industry has no preference. Nevertheless, while we endorse the argument in § 21, we think that the “credibility” requirement should envisage the utilization of the agency’s ratings by at least two banks, so as to guarantee, along with “credibility”, also the requirement of “independence”.

Italian banks also appreciate the intention to facilitate and speed up the joint assessment of ECAIs by Member States, with the provision in §37 of a deadline of one month from receipt of the request for recognition. However, explicit determination of the time within which the result of the assessment must be communicated is also necessary, in order to produce certainty over the duration of the assessment process. For the same purpose, it would be better if recognition of ECAIs were accorded at the level of the group rather than the individual subsidiaries. It’s worth focusing on coordination process in order to facilitate the joint recognition and identify solutions in case of disagreement among supervisory authorities. Moreover, we ask to specify that the “facilitator” – with the tasks of coordinating and producing the joint assessment (§ 39) – could be nominated among CEBS members.

In case of indirect recognition it would be useful to identify:

- minimum criteria for assessment before the recognition;
- the reason of an eventual refusal

An authority’s deletion of an ECAI from the official list of eligible rating agencies for supervisory purposes (§ 64) should be promptly and sufficiently communicated to the banking system; and banks should be allowed a reasonable period of time to adjust their supervisory capital. It would also be good for the revocation of eligibility to be considered as temporary.

Moreover, with regard to transparency and disclosure criteria (§102-105), we propose to define a set of standard information in order to allow possible cross-country comparison.

It is necessary to define specifically the criteria to identify the relevant market aspects: it would be useful to assess ECAIS' eligibility for single country/ or business aspects as well, in order to facilitate the recognition of ECAI specialised in issuing rating for specific customers' segments.

About securitization, expected loss is more appropriate for the assess of the rating.

With reference to Export Credit Agencies (ECAs), it is not clear whether § 162 means that utilization of the judgments on the holdings of a specific portfolio prevents the use of ECAIs' ratings with respect to other holdings within the same portfolio. While we agree with the CEBS's judgments on the potential risks of arbitrage, it should be considered that banks may well have very few exposures subject to ECA ratings, which could induce them to use the ECAIs' ratings and treat their other positions as unrated.

Finally, we propose to insert in the Common Basis Application Pack information about the segmentation of the SMEs portfolio of ECAI.

ABI Amendments to CRD

Annex VI – Part. 2 Recognition of ECAI and mapping of their credit assessments

3.- MAPPING

14. Competent authorities shall compare default rates experienced for each credit assessment of a particular ECAI and compare them with a benchmark built on the basis of default rates experienced by other ECAIs on population of issuers that the competent authorities believes to present an equivalent level of credit risk.

15. When competent authorities believe that the default rates experienced for the credit assessment of a particular ECAI are materially and systematically higher than the benchmark, competent authorities shall assign a higher risk step in the credit quality assessment scale to the ECAI credit assessment.

16. When competent authorities have increased the associated risk weight for a specific credit assessment of a particular ECAI, if the ECAI demonstrates that the default rates experienced for its credit assessment are no longer materially and systematically higher than the benchmark, competent authorities may decide to restore the original step in the credit quality assessment scale for the ECAI credit assessment.

3. MAPPING

14. To help ensure that a particular risk weight is appropriate for a particular credit risk assessment, the supervisors shall evaluate the cumulative default rate (CDR) associated with all issues assigned the same credit risk rating. Supervisors shall evaluate two separate measures of CDRs associated with each risk rating, using in both cases the CDR measured over a three-year period.

15. To ensure that supervisors have a sense of the long-run default experience over time, supervisors shall evaluate the ten-year average of the three-year CDR when this depth of data is available. For new rating agencies or for those that have compiled less than ten years of default data, supervisors may ask rating agencies what they believe the 10-year average of the three-year CDR would be for each risk rating and hold them accountable for such an evaluation thereafter for the purpose of risk weighting the claims they rate.

16. Supervisors shall consider the most recent three-year CDR associated with each credit risk assessment of an ECAI.

17. Both measurements will be compared to aggregate, historical default rates of credit risk assessments that were compiled by supervisors and that are believed to represent an equivalent level of credit risk.

18. Supervisors shall be able to compare the default experience of a particular ECAIs assessments with those issued by other rating agencies, in particular major agencies rating a similar population.

19. Each of the CDR measures mentioned above could be compared to the following reference and benchmark values of CDRs:

- **For each step in an ECAI's rating scale, a ten-year average of the three-year CDR would be compared to a long run "reference" three-year CDR that will represent a sense of the long-run international default experience of risk assessments.**
- **Likewise, for each step in the ECAI's rating scale, the two most recent three-year CDR will be compared to "benchmarks" for CDRs. This comparison will be intended to determinate whether the ECAI's most recent record of assessing credit risk remains within the CDR supervisory benchmarks.**

3.1 Comparing an ECAI's long-run average 3-year CDR to a long-run "reference" CDR.

20. For each credit risk category under Articles 78 to 83, the corresponding long-run reference CDR will provide information to supervisors on what its default experience has been internationally. The long run CDRs are meant as guidance for supervisors. The recommended long-run "reference" three-year CDRs for each of the credit risk categories are presented in Table below or alternatively based on the observations of default experience reported by major rating agencies internationally.

Proposed long run "reference" 3 year CDRs

Assessment	1	2	3	4	5
20 year average of 3 year CDR	0,1 %	0,25 %	1%	7,5%	20%

3.2 Comparing an ECAI's most recent 3-year CDR to CDR Benchmark

21. To assist supervisors in interpreting whether a CDR falls within an acceptable range for a risk rating to qualify for a particular risk weight, two benchmarks are set for each assessment, namely a "monitoring" level benchmark and a "trigger" level benchmark.

3.2.1 Monitoring level benchmark

22. Exceeding the "monitoring" level CDR benchmark implies that a rating agency's current default experience for a particular credit risk-assessment will generally still be considered eligible for the associated risk weights. Supervisors will be expected to consult with the relevant ECAI to understand why the default experience appears to be significantly worse. If supervisors determine that the higher default experience is attributable to weaker standards in assessing credit risk, they will be expected to assign a higher risk category to the ECAI's credit risk assessment.

3.2.2 "Trigger" level

23. Exceeding the "trigger" level benchmark implies that a rating agency's default experience is considerably above the international historical default experience for a particular assessment grade. If the observed three-year CDR exceeds the trigger level in two consecutive years, supervisors will be expected to move the risk assessment into a less favourable risk category. However, if supervisors determine that the higher observed CDR is not attributable to weaker assessment standards, then they may exercise judgement and retain the original risk weight.

24. In all cases where the supervisor decides to leave the risk category unchanged, it may wish to rely on Pillar 2 and encourage banks to hold more capital temporarily or to establish higher reserves.

25. When the supervisor has increased the associated risk category, there will be the opportunity for the assessment to again map to the original risk category if the ECAI is able to demonstrate that its three-year CDR falls and remains below the monitoring level for two consecutive years.

3.2.3 Calibrating the benchmark CDRs

26. The Monitoring and Trigger Level derived for each risk assessment category are presented in table below or alternatively based on historical default data from major international rating agencies.

Proposed 3 year CDR benchmark

Assessment	1	2	3	4	5
Monitoring level	0,8%	1%	2,4%	11%	28,6%
Trigger level	1,2%	1,3%	3%	12,4%	35%

Justification

The proposed Directive only partly transposes the requirements imposed by the Basel Accord of 26 June 2004 for recognition of External Credit Assessment Institutions. In fact, it does not contemplate the operational requirements of Annex 2 of the Basel Committee document, namely – for the calibration of the rating system – a significant track record of data (over a time horizon of at least 10 years) and observance of specific benchmarks on cumulative default rates, based on historical default data released by the main international rating agencies. In addition to providing for the full transposition of the new Basel Accord, the amendment makes for greater rigour in authorizing and recognizing the new rating agencies and guarantees the reliability of the judgments the ECAIs issue on the borrower’s creditworthiness.

Annex VI – Part. 2

Credibility and market acceptance

8.
(...)

9.
(c) whether there is any pricing on basis of the rating

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(...)

9.
(c) whether there is any pricing on basis of the rating

(d) in case at least two banks use the ECAI's individual credit assessment for bond issuing and/or assessing credit risks.

Justification

In order to ensure the full credibility of ECAI's individual credit assessment, the amendment makes for greater rigour in authorising and recognising the new rating agencies and guarantees the reliability of the judgements the ECAIs issue on the borrower's creditworthiness. As a matter of fact, market credibility is one of the most important requirements for recognising the ECAI's eligibility, and market acceptance represents a significant proof of the ECAI's reliability.