ABI

ASSOCIAZIONE BANCARIA ITALIANA

ABI's position on CESR's Consultation Paper on the regulation of Rating Agencies

In preparing this paper on the position of the Italian banking industry concerning the proposals set out in the CESR consultation paper on rating agencies, ABI systematically gathered the various points of view of its member banks.

On the basis of the comments we have received and the work of several ad hoc interbank working groups, ABI has drafted the present paper. It has been approved by our Executive Committee and forwarded to the supervisory authorities.

January 2005

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1. Introduction

Credit Risk Agencies (CRAs) play an important role in domestic and cross-border transactions. Economically, rating agencies help to reduce informational asymmetry between the lender bank and the borrower – or between the issuer of a security and the investor who purchases it – concerning the issuer's real capacity to repay the debt on schedule.

Rating agencies, with their ratings, summarize the information available on the borrower, sharing it with investors for whom firm-by-firm evaluation of creditworthiness would be excessively costly. By comparison with public and private credit registries (in Italy, the *Centrale dei Rischi* or Central Credit Register), which also help reduce asymmetries by supplying reports of an issuer's credit history, rating agencies carry out additional analyses of current and prospective factors that could affect the issuer's creditworthiness also in the future.

The agency rating must not be taken as an accounting or audit certificate or as a guarantee of actual repayment. (In other words, it offers no protection to investors in case of default or failure to repay.) Nor does it represent a recommendation to sell, buy or hold securities, or a judgment on the adequacy or appropriateness of any given investment (whether loan or bond).

The rating is an "opinion" – one that the market recognizes as qualified – on the creditworthiness of a given issuer or borrower. More precisely, it is an evaluation of the capacity of an institution (firm, bank, sovereign state, etc.) to repay the entire principal and interest on its obligations according to a fixed schedule.

2. International initiatives for the regulation of Rating Agencies

A good many initiatives have been undertaken internationally to gain a better understanding of the methodologies used by rating agencies and the problems connected with their business model. The intention was to weigh the need for introducing some kind of self-regulation of rating agencies' activities, as a consequence of:

(i) the growing importance of the credit rating agencies in the credit and securities markets;
(ii) a series of recent errors in rating (Enron, Worldcom, Parmalat etc.);
(iii) the inclusion in the new Basel Capital Adequacy Accords – and hence in the Capital Requirements Directive transposing the Accord (CRD) – of external ratings in calculating banks' capital requirements.

In October 2004 the International Organization of Securities Commissions (IOSCO) released a consultlation paper on the possibility of instituting a code of conduct for the rating agencies. Following to the "Report on the activities of Credit Rating Agencies" issued by the IOSCO Technical Committee in September, the paper identifies a series of requisites for the rating agencies, bearing in particular on:

(i) <u>the quality and integrity of rating processes</u>: IOSCO urges that the processes whereby ratings are assigned be rigorous, based on methodologies that permit objective valuation. Rating systems must be constantly monitored and updated, and the agencies must conform with the laws and regulations of the countries in which they operate;
(ii) <u>the independence of the agencies</u>: Ratings must be issued according to independent, objective standards. Procedures and analysts must never be in situations of even seeming conflict of interest vis-à-vis the companies rated;
(iii) <u>responsibility towards issuers and investors</u>: Standards of transparency must be observed, as well as the correct handling of confidential information.

At the end of November the CESR (Committee of European Securities Regulators) released its own consultation paper on the need for European regulation of rating agencies. The paper proposes six regulatory options:

(i) registration/regulation regime 1: This regime would consist in a European system of registration of CRAs. The register would be kept and operated by a European authority (e.g., the CESR or the CEBS) and would cover agencies recognized at European level. Registration would be granted only to CRAs meeting specific requirements, on the basis of reports from national supervisory authorities.

(ii) registration/regulation regime 2: Similar to the first option, except that the eligibility requirements for registration are those established by the IOSCO Code of Conduct.

(iii) inclusion of the IOSCO Code of Conduct in the CRD: That is, transposition into the Directive of the IOSCO code.

(iv) Certification or enforcement of the IOSCO Code: This would involve designating a third party (public or private) to certify that the code of conduct adopted by any given CRA is in conformity with that of IOSCO;

(v) Rules governing only some specific aspects of CRAs;

(vi) Monitoring of market developments: No specific intervention at present, only monitoring of the market as regards issuers, investors, and rating agencies. Proposals for action would thus be considered only subsequently.

Finally, let us recall that the European Directive on capital adequacy for banks, now in course of approval by the Commission, lays down a series of requisites for the recognition of CRAs as eligible for supervisory purposes that correspond only in part with those laid down in the New Basel Accord.

3. The position of the Italian banking industry

Italian banks concur with the CESR's decision to initiate a consultation on the rules governing credit rating agencies, which are acquiring strategic importance within the credit and securities markets, in the light of the entry into force of the New Basel Capital Adequacy Accords. Italian banks agree with the requirements introduced by the IOSCO Code of Conduct, whose principles are already included, *de facto*, in the CRD as far as recognition of eligible CRAs in the prospective rules on banking supervision is concerned.

However, a simple self-regulatory code would not seem to be sufficient to regulate the activities of credit rating agencies, considering the great influence that they can exercise on financial and credit markets. Stricter regulation – which must not in any case call the independence, freedom of judgement and best practices of the main rating agencies into question – remains the best way to ensure:

(i) more objective and reliable ratings, to safeguard the stability of markets;

(ii) restriction of access to the ratings market only to agencies of the greatest reliability, to avoid the distortions that would stem from the creation of agencies with a lower quality standing. Empirical evidence[1] indicates that it is these agencies that tend to give the most favourable ratings, or to offer "unsolicited ratings"[2] as tools to penetrate the market and as such, less reliable[3];

(iii) "universal" validity of ratings, so that they are comparable over time – for all industries and all countries – and hence the absence of significant deviations in ratings ("split ratings").

"Stricter" rules are not a barrier to market entry for new rating agencies if anything, they would be an impediment to the least efficient. On the contrary, they would overcome the present situation of oligopoly, for two reasons:

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[1] Cfr Cantor, R. and Parker, F (1994), "The Credit Rating Industry", *Federal Reserve Bank of New York Quarterly Review*, 19, No.2.

[2] Under § 108 of the Basel Accords, the supervisory authorities may allow banks to use unsolicited ratings, on condition that they are not used by the rating agencies to put pressure on firms for a formal request for rating.

[3] Apart from strictly commercial purposes, these better ratings could be explained by the fact that each agency tends to rate firms by comparison with their existing "portfolio" of clients, which may not be representative of the whole population of firms (selection bias). As a consequence, a company might get a better rating from an agency that ordinarily works with riskier firms.

(i) The establishment of specific requirements would make possible the recognition of new credit rating agencies. At present, in the absence of regulation, even well qualified new agencies would have to wait for market recognition (which would require a significantly longer time).

(ii) The present, and long-standing, oligopoly held by the leading rating agencies came about precisely in the absence of specific rules and on the basis of so-called "market practices".

Given the foregoing, the Italian banking industry endorses the first two of the options proposed by the CESR, namely a plan for registration of rating agencies judged to be reliable while complying with the specific requirements; the plan should include the requirements laid down in the IOSCO Code of Conduct and those in the New Basel Accord, not yet transposed into the CRD. In short, the New Basel Accord currently provides that – having fixed a few specific benchmarks relating to default histories correlated with given rating classes as determined by the leading rating agencies – if in the long run defaults in any one of a CRA's rating classes were to exceed the benchmark by a predetermined amount, then the firms in those classes would be subjected to higher supervisory capital requirements. This would correspond, *de facto*, to withdrawal of recognition of the reliability of these ratings.

Such a procedure would carry a number of advantages:

(i) It would identify, with certainty, CRAs considered eligible by the regulators and hence by the market.

(ii) It would provide for a system of controls by supervisory authorities.

(iii) It would not be highly restrictive or such as to alter the best practices of current CRAs.

(iv) It would offer incentives for new CRAs to adopt the practices of the leading ones already operating.

(v) It would offer incentives to CRAs to constantly monitor their rating methodology.

Apart from the CESR's options, we propose the requirements laid down in the IOSCO and the New Basel Capital Accord will be transposed into the CRD.

It is our hope that both CESR and CEBS sustain the same position in this regard. The appendix sets out ABI's proposed amendment to the CRD transposing the New Capital Adequacy Accord into EU regulation.

Finally, as regards the rules of conduct envisaged by the CESR paper, let us note the need to:

(i) introduce additional requirements that can move the rating agencies towards greater "reactivity" and "rapid response" in the case of various possible events (endogenous or outside contingencies) that could lead them to revise their ratings[4];

(ii) institute limits on CRAs' business in "auxiliary" services (such as financial consulting) to firms being rated.

ABI position is not fully endorsed by FBE which supports that the correct framework for CRAs is self-regulation based on compliance with the IOSCO Code of Conduct Fundamentals. However, FBE believes that compliance with the IOSCO Code should be the basis for recognition of CRAs under the Capital Requirements Directive.

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[4] As a rule, the agencies change their ratings after a period of "creditwatch". Sometimes the interval between the announcement of the creditwatch and the release of the new rating is so long that the market often seems to have already discounted the change.

Appendix: ABI's proposed amendment to the CDR

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 then 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 year, 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%

Motivation

The proposed Directive only partly transposes the requirements laid down in the Basel Accord of 26 June 2004 on recognition of rating agencies (External Credit Assessment Institutions, ECAIs). The proposal does not contemplate the operational requirements set out in Annex 2 to the Basel Committee paper for the calibration of the rating system, the ability to produce data that are reliable over time (a time horizon of at least 10 years) and observance, as regards the cumulative default rate, of specific benchmarks calculated with reference to time series on the experience of the leading international rating agencies. In addition to permitting the full transposition of the Basel Accord, the proposed amendment also provides for greater rigour in the standards for recognition and authorization of ECAIs and thus makes their ratings themselves more reliable.