EBA Banking Stakeholder Group's response to the Consultation Paper (JC/CP/2014/01) of EBA, ESMA and EIOPA on the Draft Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation—CRR

Although the general reliance on credit rating agencies in regulatory matters should be tuned down in accordance with recent amendments of CRA Regulation, the BSG appreciates the steps taken to open the European market for more credit rating agencies in addition to the three main incumbents. The comparison and the mapping of the ratings are of crucial importance in the process to provide help not only to the institutions which use the external credit ratings for their own capital adequacy calculation and/or in their credit processes, but also for investors in securities in making their investment decisions. The mapping methodology and the concrete mappings of credit ratings to credit quality steps of the CRR is increased by the fact that it will precede the report to be prepared by ESMA on the possibility of establishing one or more mappings of credit ratings to be submitted in accordance with Article 21. 4. b. of the Regulation No. 1060/2090/EC on ECAI.

In the CRR it is underlined that institutions should not only rely on external credit assessments but are encouraged to also use internal ratings. The small institutions which generally do not have sufficient data or expertise to develop an expected loss model will use the standardised approach and the assessment of the ECAIs in the longer term. Therefore, the ITS will not only be applied by institutions where the credit risk is less material (see page 5), but also by small credit institutions where credit risk is normally the most important risk type.

The mapping of credit assessments made by the ECAIs through the credit quality steps are also important from a customer perspective as, in a wider context, there is generally a link between the rating of a bank's customer by an ECAI and the pricing of products to that specific customer. The mapping of rating assessments to credit quality steps must therefore mirror the real differences in risk as measured by the differences in observed default rates by rating category over a long period of time. In this way allocations of the different rating assessments to the different risk weights can be justified. The provisions made in the ITS for later adjustments of rating assessments to credit quality steps due to changes in default rates of different rating assessment categories must also be related to this principle.

We interpret the term “relative differences of risk” (as used in item (3) in the recitals of the proposed Implementing Regulation) as a way of expressing the principle referred to in the above paragraph. The differences in risk, as expressed by default rates and as represented by ECAI ratings, should be mirrored and be comparable to differences in risks in the credit quality steps, and subsequently in the risk weights applied, taking into account the given number of credit quality steps. We feel that the principle should be spelled out more clearly in the proposed regulation.

In several Member States, which formerly opted for the central government based method to determine the risk weights for institutions and regional governments, the importance of the credit assessments of the nominated ECAIs has been increased by the CRR. Therefore all Member States are now applying the risk weights of exposures to rated institutions and regional authorities as determined by their external ratings by the relevant ECAIs and are applying mapping of those rating categories to the credit quality steps. As a result of these changes, the quantity of the overall capital requirement under the CRR for rated items has already been adjusted in the Member States which formerly opted for the central government based methods. Therefore the maintenance of the overall level of capital cannot be a very important element in the mapping decision.

The use of the external credit assessments in determining credit quality steps should require not only the transparency of the mapping methodology and the disclosure of the final result of the mapping, but in our view, also that the main drivers of the mapping process and relevant decisions (e.g. the default rates for the different ECAIs credit assessment categories) should be published.

The transparency of the mapping decisions is a core issue also in highlighting the relationship between the long-term and short-term ratings. Neither Annex 2 of the Basel II framework, nor the present proposed ITS, reveal the mapping of short-term credit assessments to credit quality steps. While we consider the internal relationship between long-term and short-term ratings established by the ECAI to be important, we believe that other factors should also be considered for the mapping of short-term and other credit assessments, such as those for the CIUs (see point 26 at page 40). The mapping methodology and the concrete mappings of the short-term ratings should be basically treated in the same way as the long-term credit assessment, including the description of the methodology and also the disclosure of the concrete mapping decisions.

The mapping process should be designed in such a way as to avoid the possibility that some credit quality steps in the short-term assessments are mapped to higher risk weights than long-term credit assessments. This has been the case in the past (see the description of the anomalies in the Annex below). In general, institutions, regional authorities and companies are rarely rated better than the sovereign issuer in which they are registered.

Though we are aware that the number of the CQSs is determined by the CRR, in general we believe that from the CQS2 there are too few credit quality steps compared to the default experience observed at the ECAIs. This fact also makes it more difficult to make a fair differentiation of risk weighting (and therefore also a fair differentiation of pricing to customers – ref paragraph 3 above) reflecting the differentiation in the risk assessments of the ECAIs.

The recitals (16) seem very wide and unclear, unless defined and spelled out in more detail. We suppose the intention is not to overrule the risk evaluation and rating set by an ECAI.

The practical application and resulting effects on the mapping related to the defined "long-run benchmarks" and "short-run benchmark" as applied in the proposed ITS are not clear to us.

Finally, it would be useful, if some parts of the explanatory texts for consultation, which increase the transparency of the mapping methodology (such as the adjustments due to the differences in the definition of default) were included in the text of the ITS.

This draft ITS raises some complex issues. From time to time the BSG becomes concerned that excess complexity is being introduced into some aspects of regulation. Whilst it recognises that complex issues sometimes need to be addressed by complex regulation, this is not always the case. The BSG strongly sympathises with EBA's efforts to avoid unnecessary complexity and strongly encourages such efforts as part of its proportionality commitment.

ANSWERS TO THE QUESTIONS

Q1. Do you agree with the proposed selection of quantitative factors to differentiate between the different levels of risk in each rating category?

We agree that the short-run default rates should be measured over a 3-year time horizon, and also that where there is evidence that an item or an entity has ceased to be rated in the 3 year time horizon prior to default, that must be considered as a defaulted item. However, in our view, it is too conservative to assume that all the items withdrawn prior to the time horizon should be treated by 50%. Though, depending on their policy, most rating agencies continue to prepare unsolicited ratings when a company ceases to order to be rated, it may happen, especially in case of issue ratings, that the ECAI stops rating the company. Therefore it is suggested to apply a more sophisticated approach for the treatment of those companies which have been rated at the beginning of the time horizon, but are not present in the pool at the end of the time horizon.

It is not clear to us whether the short-run default rates would serve as a starting point for mapping the short-term ratings to the credit quality steps for the exposure class ‘exposures to institutions and corporates with a short term credit assessment”.

Short-run default rates should apply to adjustments of allocation of ratings to the credit quality steps not only reflecting increases in risks, but also reductions (ref. recitals (12)).

To include in article 3 (6) the default definition items which have not caused any materialised financial loss to the holder of the asset seems strange. In our view, the disbursement delay should be concretely defined (e.g. past due X days) and the distressed exchange should be more precisely described. It is not clear how the ECAIs or regulators (which do not collect such data) should obtain the necessary information. Only defaulting items causing realised financial losses and not expected losses should be included. If not, an expected default not materialising should count positively in the next round of evaluation, which again does not seem right for evaluating the real assessment and evolution of risk.

Q2. Do you agree with the proposed definition of sufficient for the number of credit ratings and the rest of the requirements imposed for the calculation of the short run default rate when a sufficient number of credit ratings is available?

We understand that it is very difficult to exactly define the sufficient number of credit ratings. However, as the number of the credit assessments can have an influence on the default rates, both the default rates and the number of the ratings used to define the default rates should be published as part of the mapping decision. As already noted, we emphasise that transparency in the mapping process is an important requirement.

Q3. Do you agree with the proposed requirements imposed for the calculation of the long-run default rate when a sufficient number of credit ratings is available?

Yes, basically, we do agree with it. However, it is not very clear what the reference periods are for the estimated default rates, where less than 20 but at least 10 short run default rates, can be calculated. If they relate to the period prior to the one of the observed default rates, it is not clear why the figures for the most recent period are used for weighting the estimated rates.

The definition of the initial long-run default rate could be more precise and direct. The assignment of both short-term and long-term ratings to the credit quality steps must initially be based on observations of default rates for a long time horizon.

The interpretation and implications of the expression "refer to the most recent recessionary period" in paragraph 4 and the explanatory text is not clear. For cyclical businesses, ECAIs tend to look through the cycles and evaluate the risk based on normal and sustainable price and earnings levels.

Q4. Do you agree with the proposed options to calculate the quantitative factors when a sufficient number of credit ratings is not available?

We agree with the approach in cases where a sufficient number of credit ratings is not available, but where a sufficient number of items assigned a different measure of creditworthiness is available. However, in other cases, where there is neither a sufficient number of credit ratings nor a sufficient number of items assigned a different measure of creditworthiness, the assessment of the long-term default rate regulated in Article 7 is less clear. Although the implicit uncertainty in these cases is quite high, as a starting point it could be acceptable to use estimates provided by the ECAI of the long-run default rate, but the adjustment should be much more comprehensive and include other factors in addition to the method presented in Article 7 (2).

Q5. Do you agree with the proposed use of the default definition used by the ECAI as a relevant factor for the mapping? Do you agree with the proposed assessment of the comparability of the default definition of an ECAI? If not, what alternatives would you *propose? Do you think that the adjustment factor depends on certain characteristics of the rated firms such as size and credit quality and if so, how can this be reflected?*

Yes, we agree that the definition of default must be an important, if not the most important, qualitative factor in the mapping process. We believe that the definition of default has to be as near as possible to the definition of default in Article 178 of the CRR. In our view, the methodology applied to how the default rates are adjusted should be included in the text. However, as discussed under Q2, including in the definition of default some cases which are not causing materialised financial losses for the holder of the asset, might also cause difficulties. The same is the situation in cases when the regulatory definition of default is not considered a default in the underlying agreement.

Q6. Do you agree with the proposed use of the time horizon of the rating category as a relevant factor for the mapping? Do you agree with the proposed use of transition probabilities to identify the expected level of risk during the three-year horizon?

Yes, we agree with it.

Q7. Do you agree with the proposed use of the range and meaning of credit assessments as a relevant factor for the mapping? Do you agree with the proposed restriction of this factor to adjacent rating categories?

The usefulness of the meaning of credit assessment depends to a great extent on the number of the rating categories and whether or not the meaning of the credit assessments is well explained. While we fully agree that the mapping of one rating category to a credit quality step should not be the basis of mapping all the rating categories of that specific ECAI to the credit quality steps, we believe that the restriction to use this factor only for mapping the adjacent categories might prove too restrictive when the number of rating categories is much more than the number of the credit quality steps.

Q8. Do you agree with the proposed use of the risk profile of a credit assessment as a relevant factor for the mapping?

In general, we agree that the risk profile should be considered in the mapping process. We are aware that, in the master scale of many institutions, medium-sized companies cannot qualify for the best ratings. However, we are not sure that the size without the diversification of activities and counterparties (suppliers, buyers) would alone be a factor which should drive to a lower risk weight.

It should be noted that most well-run companies are not opting for the highest possible credit rating. A high rating can limit the capacity to raise external loan funding, due to ECAI's rating benchmarks, and therefore limit the capacity to grow. A rating in the mid-range of investment grade is normally the rating ambition (or risk appetite) which normally seems to benefit the company for securing future generation of cash flow, thereby servicing their shareholders, bondholders and lenders in the most optimal way.

Q9. Do you agree with the proposed use of the estimate provided by the ECAI for the long-run default rate associated with all items assigned the same rating category as a relevant factor for the mapping? Do you agree with the proposed role played by this factor depending on the availability of default data for the rating category?

We think that the draft text on the use of the estimate provided by the ECAI is too general. It is not clear from the text when and how the estimates would be used, and what the relationship" in the mapping process between the use of the estimated default rate under Article 7(2) and Article 13.

Q10. Do you agree with the proposed use of the internal mapping of a rating category established by the ECAI?

Yes, we do agree with it.

Q11. Do you agree with the proposed specification of the long-run and short-run benchmarks? Do you agree with the proposed mechanism to identify a weakening of assessment standards?

It is not clear whether all the conditions, or any of the conditions, should be met in order to state the weakening of the assessment standards. Our interpretation is that all those conditions are necessary, as a materially default rate in itself is not a proof for the weakening assessment standards.

In Annex 1 it has to be added that the benchmarks refer to the 3-year time horizon. We agree that lower and upper bounds have been set up for the values of the long run default rates for each CQS.

The practical application of the benchmarks and the implications for the mapping process in the proposed text of the ITS is not enough clear to us, and should be better described. Though it is very technical, we suggest to consider the inclusion of the explanatory text in the text of the ITS. In addition, the possible joint actions of the ESAs when the latest two 3-years average default rates are higher than the monitoring level or the trigger level, should be outlined.

Q12. Do you agree with the analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or which might further inform our analysis of the likely impacts of the proposals?

As we have already mentioned, the impact of mappings established by this draft ITS will be relevant for the institutions using the standardised approach, specifically in those Member States which formerly opted for the central government based method for risk weighting the exposures to institutions and regional authorities.

Another important impact is foreseen regarding the outcome of the mapping for the exposure class ‘exposures to institutions and corporates with a short term credit assessment” and for which exposures they have to be used. Unfortunately, these impacts have not been addressed in the adoption of the CRR. It is assumed that the common methodology and hopefully the disclosure of the main points in the mapping decision for an individual ECAI will facilitate the nomination of the ECAIs at the institutions using the standardised approach or relying on the ECAIs ratings for other reasons.

It is expected that the proposed mapping principles will contribute to a fair pricing of banking products based on a fair mapping and distribution of risk assessments made by the ECAIs to the corresponding credit quality steps and risk weights in the CRR.

ANNEX

Anomalies in mapping under the Directive 2006/48/EC

In 2006, the CEBS published the mapping of three ECAIs based on a joint assessment methodology. In the exposure class for institutions in the lowest investment grade categories, namely from BBB+ to BBB- or their equivalents, and the first to non-investment grade categories from BB+ and to B- or their equivalents the credit assessment based method for institutions were identified as being more risky resulted in lower risk-weights for long-term credit assessment than the short-term credit assessment. Therefore, for capital adequacy purposes in the rating categories mentioned the credit institutions were identified as being more risky for the short run than for the long run. However, in November 2006, the CRD Transposition Group[1] held the view that the short-term credit assessment is issue-specific: in case of rated banks this seems less evident. All rated institutions get a short-term credit assessments from the ECAIs which rate them, and these short-term ratings cannot be regarded as issue-specific, since the terms and conditions for the individual interbank deposits can be very different. However, on page 6 in describing the background and rationale of the ITS, it seems that, despite this fact, bank deposits are treated, as instruments.

Long term mapping except securitisations

Credit quality step	Fitch's assessments	Moody's assessments	S&P's assessments	Corporate	Institution (includes banks)		
					Sovereing method	Credit assessment method	
						Maturity > 3 months	Maturity 3 months or less
1	AAA to AA-	Aaa to Aa3	AAA to AA-	20%	20%	20%	20%
2	A+ to A-	A1 to A3	A+ to A-	50%	50%	50%	20%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	100%	100%	50%	20%
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	100%	100%	100%	50%
5	B+ to B-	B1 to B3	B+ to B-	150%	100%	100%	50%
6	CCC+ and below	Caa1 and below	CCC+ and below	150%	150%	150%	150%

Short term mapping except securitisations

Credit quality step	Fitch's assessments	Moody's assessments	S&P's assessments	Risk weight
1	F1+; F1	P1	A1+; A1	20%
2	F2	P2	A2	50%
3	F3	P3	A3	100%
4	Below F3	NP	B-1	150%

In our view, the mapping methodology should always avoid the anomalies indicated above, and that short-term assessments would be mapped to higher risk weights than

[1] See CRD Transposition Group Answer to the Question 149.

the long-term ones only if it is justified by the specific circumstances. The same is valid for issue-specific ratings. In the case of institutions, specifically, it would be necessary to see what kind of factors can divert a short-term credit assessment from the general short-term credit assessment of that institution. The public disclosure of the mapping methodology and hopefully also the main points of the mapping decision in the case of the registered or certified ECAIs could promote this.

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