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CEBS's advice to the European Commission on the non-eligibility of entities only producing credit scores for ECAI recognition

Introduction

1. CEBS sets out in this paper its advice to the European Commission on an amendment to the Directive 2006/48/EC to introduce a requirement that an External Credit Assessment Institution (hereafter, 'ECAI') has to be registered in accordance with Regulation (EC) No 1060/2009 on Credit Rating Agencies of 16 September 2009 (hereafter, '*Regulation on CRAs*' or '*Regulation*')¹ as a precondition for being recognised as an eligible ECAI for capital requirement purposes; the only possible exception being Central Banks.²
2. CEBS has published a consultation paper (CP43) on its draft advice on 13 October 2010.³ The consultation period ended on 13 November 2010 and four responses were received all of which are published on the CEBS website.⁴ One of the respondents is an international banking association representing one of the largest European retail banking networks; the other three respondents are credit assessment entities. A feedback document presenting a summary of the key points arising from the consultation and CEBS's responses is also published on the CEBS's website.

¹ The *Regulation on CRAs* is published under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF>

² The CEBS's advice was endorsed by a qualified majority of CEBS Members with the objection of two Members (France and Portugal). The French Member has objected to the proposals set out in the advice as in its opinion the objectives pursued by the Capital Requirements Directive and the *Regulation on CRAs* are different. The Portuguese Member has raised serious concerns regarding the lack of technical support of the proposals presented in the advice.

³ CP43 is published under: <http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP41-CP50/CP43.aspx>

⁴ The public responses to CP43 are published under: <http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP41-CP50/CP43/Responses-to-CP43.aspx>

Reasoning for CEBS's proposals

3. Article 4 of the *Regulation on CRAs* states that credit institutions, investment firms, and other types of institutions may use credit ratings for regulatory purposes only if they are issued by CRAs established in the Community and registered in accordance with the Regulation.
4. In this context, CEBS understands that CRAs will have to be registered in accordance with the Regulation before being considered eligible to apply for ECAI recognition.⁵ The term 'registered in accordance with the Regulation' is used here (and in the proposal for amendments to Directive 2006/48/EC) in a broad sense. CEBS is of the view that the external credit assessments that are eligible for solvency purposes are not only those issued by CRAs established in the Community and registered in accordance with the Regulation, but also all those that are endorsed by a CRA established in the Community and registered in accordance with the Regulation (Article 4.3 of the Regulation); those issued by a CRA established in a third country and that comply with the conditions stated in Article 5 of the Regulation (equivalence and certification based on equivalence) would also be eligible.
5. However, there are certain entities to which the *Regulation on CRAs* does not apply in accordance with Article 2(2)⁶ and which could – potentially – be eligible to apply for ECAI recognition without being registered in accordance with the Regulation: Central Banks and those entities only producing credit scores (Article 2(2)(b)), and Article 2(2) d)).⁷
6. In the case of Central Banks, which are excluded from the scope of the Regulation, there is a requirement that their credit ratings must be issued in accordance with the principles, standards and procedures which ensure the adequate integrity and independence of credit rating activities as provided for in the Regulation (Article 2(2)(d)(iii)).⁸

⁵ This understanding is confirmed by paragraph 3 of Article 2 of the Regulation: 'A credit rating agency shall apply for registration under this Regulation as a condition for being recognised as an External Credit Assessment Institution (ECAI) in accordance with Part 2 of Annex VI to Directive 2006/48/EC, unless it only issues the credit ratings referred to in paragraph 2.' It is also confirmed by the amendments to Articles 81(2) and 97(2) of Directive 2006/48/EC, to which the following sentence was added: 'Where an ECAI is registered as a credit rating agency in accordance with Regulation (EC) No 1060/2009 of 16 September 2009 of the European Parliament and of the Council on credit rating agencies, the competent authorities shall consider the requirements of objectivity, independence, ongoing review and transparency with respect to its assessment methodology to be satisfied.'

⁶ Article 2, paragraph 2: 'This Regulation does not apply to:

- (a) private credit ratings produced pursuant to an individual order and provided exclusively to the person who placed the order and which are not intended for public disclosure or distribution by subscription;
- (b) credit scores, credit scoring systems or similar assessments related to obligations arising from consumer, commercial or industrial relationships;
- (c) credit ratings produced by export credit agencies in accordance with point 1.3 of Part 1 of Annex VI to Directive 2006/48/EC; or
- (d) credit ratings produced by the central banks and which:
 - (i) are not paid for by the rated entity;
 - (ii) are not disclosed to the public;
 - (iii) are issued in accordance with the principles, standards and procedures which ensure the adequate integrity and independence of credit rating activities as provided for by this Regulation; and
 - (iv) do not relate to financial instruments issued by the respective central banks' Member States.'

⁷ Private credit ratings as defined in Article 2(2)(a) could never fulfill the requirements demanded to be an ECAI and credit assessments produced by export credit agencies as defined in Articles 2(2)(c) are treated in the CRD separately from credit ratings produced by ECAIs and have different eligibility requirements.

⁸ In addition, Article 2, Paragraph 4 states that: 'In order to ensure the uniform application of paragraph 2(d), the Commission may, upon submission of a request by a Member State, in accordance with the

7. From a prudential point of view, this requirement ensures that at some extent these entities will in fact meet the requirements set out in the Regulation. CEBS, therefore, agrees that Central Banks excluded from the scope of the Regulation are still eligible for ECAI recognition. In this case, the entire set of technical criteria defined in Annex VI, Part 2 of Directive 2006/48/EC has to be met before ECAI status can be granted.
8. The case of entities only producing credit scores is, however, different. Currently, the Regulation and Directive 2006/48/EC allow these entities to apply for ECAI recognition without requiring them to meet all the requirements set out in the Regulation. This leads to an unlevel playing field between CRAs and entities only producing credit scores and a lack of transparency for both supervisors and the market.
9. In addition, it is CEBS's view that, from a prudential perspective, the credit scores produced by entities that only summarize and express *'data according to a pre-set statistical system or model alone without any additional substantial rating specific analytical input from a rating analyst in the assessment process'*⁹, should not be used for capital requirement purposes. Therefore, CEBS proposes that entities only producing credit scores which are excluded from the scope of the Regulation not be considered eligible to apply for ECAI recognition.
10. CEBS clarifies that the aim of its proposals is primarily to ensure consistency between the ECAI recognition under the CRD and the Regulation. As a consequence, the CEBS's proposals would prevent the direct use of credit scores for regulatory purposes, in particular its use in the calculation of capital requirements of financial institutions. CEBS further clarifies that its proposals do not prevent in any way financial institutions from using credit scores in their internal risk management or as an input to their internal models under the IRB approach. However, it is CEBS's view that credit scores should not be used for regulatory purposes and that the recognition of an entity only producing credit scores as an eligible ECAI implies that elements that are typical for IRB models would be recognised for supervisory purposes under the Standardised Approach without having

regulatory procedure referred to in Article 38(3) and in accordance with paragraph 2(d) of this Article, adopt a decision stating that a central bank falls within the scope of that point and that its credit ratings are therefore exempt from the application of this Regulation.'

⁹ Paragraph 12 of CESR's Guidelines on Registration Process, Functioning of Colleges, Mediation Protocol, Information set out in Annex II, Information set for the application for Certification and for the assessment of CRAs systemic importance (http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=6861) makes it clear that *"The expression of such opinions requires according to the Regulation also the performance of rating specific analytical functions by a person ("rating analysts"). This performance of analytical functions should be understood as a substantial rating specific expert analysis and evaluation of information regarding creditworthiness employing significant professional knowledge, experience and analytical skills that according to the rating process must have an impact on the rating process and the outcome of the rating process. Therefore if no rating analysts are employed to arrive at a specific expression of creditworthiness of a particular entity, debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, such an expression on creditworthiness is not an opinion within the meaning of the definition of a credit rating, and consequently cannot be deemed to be a credit rating within the meaning of the CRA Regulation. Summarizing and expressing data according to a pre-set statistical system or model alone without any additional substantial rating specific analytical input from a rating analyst in the assessment process does therefore, like the activities listed in the exceptions in Article 2.2 of the Regulation (e.g. private credit ratings, credit scores and others), do not require registration according to the Regulation."*

the same strict process, implementation and validation requirements that must be fulfilled under the IRB approach.

11. CEBS acknowledges that cases might exist where the registered CRAs produce both credit ratings that fall within the scope of the Regulation and credit scores which are out-of-scope of the Regulation. It is CEBS's view that, in these cases, the registered CRA can apply for ECAI recognition, but the use of its assessments for supervisory purposes is limited to the credit ratings which fall within the scope of the Regulation.
12. CEBS notes that at present there are only a few Member States (i.e. EL, FR, IT, PT and SI) that have recognised as ECAIs entities that feature characteristics which may qualify them as credit scoring entities in accordance with the *Regulation on CRAs*. Empirical evidence provided by these Members did not indicate, in most cases, that the assessments provided by these entities represent a material input in the calculation of supervisory capital requirements, especially for systemic institutions, so that the impact of the (potential) de-recognition of credit scoring entities will be immaterial for most of these Member States.

CEBS's proposal for amendments to Directive 2006/48/EC¹⁰

13. In line with the reasoning set out above, CEBS proposes the addition of a new paragraph 1a. to Article 81 of Directive 2006/48/EC:

Article 81

1. An external credit assessment may be used to determine the risk weight of an exposure in accordance with Article 80 only if the ECAI which provides it has been recognised as eligible for those purposes by the competent authorities ('an eligible ECAI' for the purposes of this Subsection).

1a. An ECAI shall be registered in accordance with Regulation (EC) No 1060/2009 of 16 September 2009 of the European Parliament and of the Council on credit rating agencies as a precondition for being recognised as eligible for the purposes of Article 80, unless it only issues those credit ratings referred to in Article 2(2)(d) of the aforementioned Regulation.

2. The competent authorities shall recognise an ECAI as eligible for the purposes of Article 80 only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency. For those purposes, the competent authorities shall take into account the technical criteria set out in Annex VI, Part 2. Where an ECAI is registered as a credit rating agency in accordance with

¹⁰ Amended by Directive 2009/111/EC published on 17 November 2009.

Regulation (EC) No 1060/2009 of 16 September 2009 of the European Parliament and of the Council on credit rating agencies (1), the competent authorities shall consider the requirements of objectivity, independence, ongoing review and transparency with respect to its assessment methodology to be satisfied.

3. If an ECAI has been recognised as eligible by the competent authorities of a Member State, the competent authorities of other Member States may recognise that ECAI as eligible without carrying out their own evaluation process.

4. Competent authorities shall make publicly available an explanation of the recognition process, and a list of eligible ECAIs.

14. CEBS also proposes a new draft for paragraph 2 of Article 97 of Directive 2006/48/EC:

Article 97

1. An ECAI credit assessment may be used to determine the risk weight of a securitisation position in accordance with Article 96 only if the ECAI has been recognised as eligible by the competent authorities for this purpose (hereinafter 'an eligible ECAI').

2. The competent authorities shall recognise an ECAI as eligible for the purposes of paragraph 1 of this Article only if they are satisfied as to its compliance with the requirements laid down in Article 81, ~~taking into account the technical criteria set out in Annex VI, Part 2,~~ and that it has a demonstrated ability in the area of securitisation, which may be evidenced by a strong market acceptance. ~~Where an ECAI is registered as a credit rating agency in accordance with Regulation (EC) No 1060/2009, the competent authorities shall consider the requirements of objectivity, independence, ongoing review and transparency with respect to its assessment methodology to be satisfied.~~

3. If an ECAI has been recognised as eligible by the competent authorities of a Member State for the purposes of paragraph 1, the competent authorities of other Member States may recognise that ECAI as eligible for those purposes without carrying out their own evaluation process.

4. The competent authorities shall make publicly available an explanation of the recognition process and a list of eligible ECAIs.

5. To be used for the purposes of paragraph 1, a credit assessment of an eligible ECAI shall comply with the principles of credibility and transparency as elaborated in Annex IX, Part 3.