ZENTRALER KREDITAUSSCHUSS

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Comments of the Zentraler Kreditausschuss[1] on the Consultation Paper on the recognition of External Credit Assessment Institutions of the Committee of European Banking Supervisors

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1 The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)* for the co-operative banks, the *Bundesverband deutscher Banken (BdB)* for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)* for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)* for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

I. General remarks

The German banking industry thanks CEBS for the opportunity to comment on its proposals concerning the recognition of external credit rating agencies whose ratings may be used by banks for determining the risk weights of their exposures when calculating capital requirements under the standardised approach.

In the view of the Zentraler Kreditausschuss, the recognition of external credit rating agencies for the purposes of the CRD should be based on the following principles:

- External agencies whose credit ratings are to be used by banks for determining capital requirements under the CRD must satisfy stringent requirements with respect to their methodology, the qualifications and skills of their staff and their internal organisation. This is necessary to guarantee the stability of the banks and the financial markets.
- Implementation of the CRD's prudential criteria for recognising external credit rating agencies as ECAIs should make explicit reference to internationally agreed standards for the activities of credit rating agencies.
- The recognition process should – while taking account of the allocation of responsibilities between the competent supervisory authorities – be based on clear-cut criteria, be straightforward and give rise to minimum red tape for the credit rating agencies and the banks. National specifications in recognising credit rating agencies should be reduced to a minimum in order to encourage maximum use of joint evaluations and indirect recognition.
- Incentives for regulatory arbitrage due to differences in recognition criteria from one member state to another should be avoided.
- Without lowering the necessary quality standards, the recognition process should, as far as possible, avoid erecting further barriers to market access for potential new competitors in the market for external credit ratings.

The German banking industry believes that CEBS's proposals generally strike a sound balance between these criteria. Our views on the specific questions raised in the paper are as follows:

II. Comments on the three main issues covered by the consultation paper

Part 1 The recognition process

If external credit rating agencies apply for recognition in several member states, or if financial institutions apply for the recognition of the same ECAI in more than one member state, we believe it is absolutely essential that the competent authorities involved apply to the same procedure. It would be completely illogical to give a credit rating agency either full or partial recognition in some member states but not in others. Such a situation would give rise to considerable uncertainty and unnecessary bureaucracy at the banks and encourage regulatory arbitrage. The German banking industry therefore welcomes the fact that the competent authorities have agreed on common procedures, a comprehensive exchange of information and common criteria and intend to apply a “joint assessment process” to agencies applying for recognition in more than one member state (para. 34). This will help bring about an appropriate level of convergence of supervisory practices in the European internal market. It should, however, be ensured that the joint assessment process is conducted as speedily as possible. We assume that the period of one month after receipt of application mentioned in para. 37 is intended to cover not only the meeting of competent authorities but also the assessment itself.

In addition, we recommend that national authorities exercise their legal option to consider specific national issues in the recognition of credit rating agencies (para. 42) only in very exceptional circumstances and only if this will produce no appreciable competitive distortions on the national or European banking market. This should be spelled out more clearly than at present. For the reasons outlined above, we are also in favour of applying the indirect recognition process as extensively as possible and extending it at least to EEA member states and countries such as Switzerland. We consider it unnecessary to allow for national discretion with respect, for example, to the definition of eligible applicants for the recognition process (cf. paras 12 and 20: credit rating agencies and/or financial institutions). We favour permitting a broad and consistent range of possible applicants.

Under the rule proposed in paras. 13 and 21, a competent authority may process a credit rating agency’s application only if at least one financial institution intends to use its ratings for risk-weighting purposes. This needs to be reconsidered, in our view. Requiring competent authorities to process unnecessary applications and thus carry out superfluous administrative tasks should clearly be avoided as far as possible. Nevertheless, financial institutions are likely to give notice of such an intention only if the agency involved can demonstrate a certain track record of issuing ratings that actually lend themselves to use for prudential purposes. This, together with other rules set out in the CRD and the consultation paper, will limit the

number of potential applicants. In any event, the rule should clarify that, if a bank declares its intention to use an agency's rating to calculate its capital requirements or proposes that a particular credit rating agency be recognised as an ECAI, this will not constitute an obligation to actually use the rating in practice. This would not be appropriate, since events may take place between application and recognition that result in the bank no longer needing or wishing to use the rating.

We believe it is in the interest of consistency for a credit rating agency to be given joint recognition by several competent authorities only if it can be ensured that the same rating approach is applied throughout the agency (paras. 25-29). We therefore support CEBS's intention to conduct separate recognition processes if this is in doubt.

We would also like to draw attention to the following points:

- According to para. 11, financial institutions are to retain ultimate responsibility, regardless of the recognition process prescribed by the CRD, for assessing whether an ECAI's credit ratings are appropriate for risk weighting purposes. It should be made clearer what is meant by "responsibility" exactly. If a credit rating agency satisfies the criteria set out in the directive and is recognised by the competent authorities, there is only room for separate responsibility on the part of the bank in the event of obvious and considerable doubts about a specific rating issued by the agency in question.
- Para. 45 envisages that, in the interests of confidentiality, the result of a joint assessment should not be disclosed to competent authorities in countries where no application for recognition of the credit rating agency was received without the ECAI's prior consent. This should cease to apply, in our view, if an application is submitted to a previously uninvolved competent authority at a later date. It should then be possible to pass on the information without delay; this should be made clear in the paper.

Part 2 The eligibility criteria

1. General

In the course of the discussions about the role and activities of rating agencies, the German banking industry has always stressed the need to ensure that the credit ratings issued by such agencies are reliable. This is because ratings do not only make an important contribution to the efficiency of the financial markets, but are also increasingly being used as evaluation criteria by lawmakers and central banks. A major prerequisite for achieving this reliability is a high-quality, objective and transparent rating process.

At the end of last year IOSCO published its "Code of Conduct Fundamentals for Credit Rating Agencies". The code offers a sound basis for self-regulation by the agencies and sets out important criteria for ensuring quality, independence and transparency and avoiding conflicts of interest. When applying the CRD's legally binding criteria for the recognition of ratings in the EU for prudential purposes, supervisors should, wherever possible, use this internationally accepted standard as a basis. In the interests of maximum compatibility, we believe it would make good sense to make explicit reference to the IOSCO Code when implementing the provisions of the CRD.

The recognition process should not give rise to any registration or licensing of credit rating agencies in the EU. We therefore welcome the clarification in para 2 of CEBS's executive summary that the recognition of agencies as ECAIs is not intended to constitute any kind of regulation of credit rating agencies.

2. Methodology

a) Objectivity

The rules on the methodology to be applied by credit rating agencies should confine themselves to general principles that have to be satisfied by all rating methods. Such important general principles are a systematic structure, precision, exclusive focus on facts, consideration of the special features of issuer groups, markets, market segments and types of product, the consideration of circumstances specific to atypical cases and, as far as possible, their objective validation against historical data.

Any rules on the specific form of rating methodologies going beyond those mentioned above would serve no useful purpose in our view. They would undermine competition among agencies for the most effective system, which is key to the ongoing development of the rating process, and would make it more difficult to adapt methodologies to changing market conditions. Such detailed rules would frustrate rather than promote the role of ratings as a reliable means of providing capital market information and evaluating the creditworthiness of borrowers. We therefore warmly welcome the statement that the competent authorities do not intend to endorse any specific type of methodology (paras. 81 f., 86).

We support CEBS's approach of assessing rating methodologies on the basis of three broad market segments, for each of which separate recognition will be required (paras. 77-80). This takes account of the fact that, from a rating perspective, these are very different asset classes and pose quite different challenges to the rating process. Furthermore, it recognises that, despite certain differences in matters of detail, ratings within each segment largely follow the

same criteria. Refraining from further subdivision into more than three asset classes avoids fragmentation of the recognition process and of recognised rating agencies.

b) Independence

The German banking industry believes that the independence of the credit rating agencies and the existence of procedures to avoid or disclose potential conflicts of interest are preconditions for meaningful ratings. They are equally important both for banks wishing to use external ratings to calculate their capital requirements and for the competent authorities which have to assess the quality of the ratings.

CEBS's comments on the technical criteria listed in Annex VI, Part 2, paras. 2 and 3 of the CRD, though based on the IOSCO Code, do not explicitly refer to all the cases and procedures mentioned there. In order to ensure that the code's rules – which in our view should form the basis of any ECAI recognition – are comprehensively applied, this section should include a general reference to Chapter 2 of the IOSCO Code. This would also be an incentive for credit rating agencies to comply with the code.

To establish compatibility with the IOSCO Code, credit rating agencies should not only "consider" disclosing situations where conflicts of interest have arisen or may arise (para. 92g). Such disclosure should be mandatory (section 2.6 of the IOSCO Code).

c) Ongoing review

CEBS's clarification of the interpretation of the rules in Annex VI, Part 2 of the CRD is generally sound in the view of the German banking industry. We also consider it sufficient for the competent authorities to verify that ECAIs have appropriate internal procedures in place to be able to adapt their ratings to changing conditions (para. 95). A reference to the IOSCO Code would also be helpful here.

The rule that rating agencies must review their ratings on an ongoing basis – and at least once a year – is extremely important for banks wishing to use external ratings because this will ensure that the credit assessments are always up-to-date (para. 96). Moreover, it will encourage credit rating agencies make regular reviews of their ratings a general practice.

The information that credit rating agencies are required to provide to the competent authorities as part of the ongoing review should correspond at least to those information which agencies have to disclose to issuers and the public under Chapter 3 of the IOSCO Code. Prompt advice of any intended methodological changes (para. 99) is a key information

requirement in the banks' view, since this guarantees that external ratings used for prudential purposes will remain of high quality even after an agency has gained recognition as an ECAI.

d) Transparency and disclosure

The paper's comments on Annex VI, Part 2, para. 7 of the CRD allow for a number of possible interpretations. In the interests of clarity, credit rating agencies applying for recognition as ECAIs should be required to apply the disclosure obligations according to internationally agreed standards.

Part 3 Mapping

The German banks believe it is indispensable for Europe's supervisory authorities to follow a consistent approach when mapping the ratings of external credit rating agencies to credit quality steps. Under no circumstances should different competent authorities assign different risk weights to the same rating issued by a single credit rating agency. This would lead to competitive distortions and regulatory arbitrage. The ZKA therefore strongly advocates that the consistent mapping of the credit assessments of external credit rating agencies be an integral part of the supervisory co-operation during the common recognition process.

We share CEBS's view that the rules in the CRD on the form of a consistent mapping process are sufficiently precise. The ZKA does not see a need for any mapping requirements which go beyond the technical criteria set out in Annex VI, Part 2 and Annex IX of the CRD.

The following points should also be taken into account:

- It is key to the reliability of the rating results that the default rates calculated by external credit rating agencies should be continuously monitored by the competent authorities and that mapping should be adjusted if necessary (paras. 120 and 125).
- If there is insufficient quantitative data to use as a basis for mapping, it is important for the competent authorities to be sufficiently flexible and consider other available data, such as the credit rating agencies' own assessments (paras. 121-122).
- It is perfectly correct to apply an appropriately conservative approach when using qualitative information and comparisons (para. 122). Nevertheless, supervisors should refrain from making or presupposing unnecessarily restrictive assumptions about practices employed by credit rating agencies and banks.

As far as quantitative criteria are concerned, we welcome the reference to the guidelines provided by the Basel Committee. This will help to establish an international level playing field.

The Basel guidelines raise several questions, however. First, the status of the long-term three-year CDRs is unclear. As we understand it, only the last two three-year CDRs need to be considered for the purposes of mapping to a prudential credit assessment level. It is also open to question which prudential credit assessment levels and thus, above all, which risk weights are meant to correspond to the five columns in Annex 2 of the Basel Revised Framework.

The mapping of the Basel Framework's "sovereign" and "banks" exposure classes is fairly straightforward since these also have five credit assessment steps for rated exposures. The terminology used is not always identical, however. In particular, it is not clear whether the "below B-" category is intended to be identical to Category B in Tables 2 and 3 of Annex 2 of the Basel Revised Framework. The mapping of exposures to corporates is more difficult. Only four credit assessment levels are envisaged here. It is unclear whether levels BBB and BB can be consolidated into one assessment level which will be allocated a risk weight of 100%.

Using the format from Annex VI of the CRD will be even more problematic. Here, all exposures have six credit assessment levels.