CEBS

Comments on the Consultation Paper on the Recognition of External Credit Assessment Institutions

Trieste, September 30 2005

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1. EXECUTIVE SUMMARY

EU-RA EUROPE RATING S.P.A.

OVERVIEW

Eu-Ra Europe Rating S.p.A. elaborates methodologies, technologies and analysis procedures, exploiting advanced scientific information for the interpretation of the state of health and the solvency level of enterprises or other systems issuing a rating attribution.
Eu-Ra Europe Rating S.p.A. is engaged in research activity with the aim of creating new prototypes, embodied in softwares, oriented to the production of patents in financial and rating fields.
Eu-Ra Europe Rating S.p.A. participates in national and international research programs, with particular regard to production and implementation of know-how in its operational field.
Eu-Ra Europe Rating S.p.A. started as a result of the evolution of the new Basel regulation. The instructions of Basel 2 imply that banks must make explicit the link existing between credit risk and pricing for clients. On the basis of the Basel agreement, which will be in operation from 2006, banks of countries involved will have to estimate correctly the risk of credit default and will have to protect themselves with greater capitalization.
The cultural background of Eu-Ra Europe Rating S.p.A. is the Research Doctorate in Corporate Finance of the University of Trieste with the collaboration of Italian universities (Milan Bocconi, Udine, Bologna, Siena, Florence, Rome La Sapienza). The Research Doctorate, jointly with important financial institutions, is developing accurate and experimented know-how in several functions of Modern Corporate Finance and in the role and structure of financial markets.
Eu-Ra Europe Rating S.p.A. works with university professors, Ph.Ds and postgraduate students in Corporate Finance, professionals and financial experts in Asset Management. The company makes use of the most modern analysis techniques in the field of Financial Engineering.

2. COMMENTS

It is not our intention to discuss all the issues brought up in the document “Consultation Paper on the Recognition of External Credit Assessment Institutions”, but we would like to offer opinions regarding a few of them.
In the first place, we would like to address the problem of not creating any barriers to entry of new agencies which are fully competent, methodologically sound and which would be able to respond to the criteria outlined in the “International Convergence of Capital Measurement and Capital Standards” document of the Basel Committee on Banking Supervision. We agree with the recommendations contained in the European Parliament Report of 29 January 2004. In Italy, as in other parts of Europe where the position of the financial market is weak, the leading institutions (both financial and other types) are not actively engaged in the creation of new Rating Agencies, in spite of the importance of developing a risk culture and of assessing the probability of default relating to various types of entities. Your Consultation Paper contains much in the nature of excessive bureaucracy with regard to infant agencies. We would not wish the methodology proposed in the document, and its restrictions, to result in an exclusive advantage for the banking sector. The present situation in Italy, where the banking sector is dominant, presents particular difficulties for opening a market for rating agencies. Therefore, it is important that the stringent regulations outlined in your document should also apply to the banking sector (regarding IRB) so that competive parity may be achieved. It is important to bear in mind that in our economy rating assessment should coincide with innovative methodology. To this end, great care by your team of experts should be given to ensure that the general regulations do not penalise the best players.

IN RESPONSE TO THE FOLLOWING QUESTIONS

1) If you are an institution or an ECAI, how do you envisage using the proposed recognition process, in particular in cases where applications for the same ECAI are submitted in more than one Member State at the same time?

It is our opinion that, at present, there are, in each Member State, differing methods of approach of research and risk awareness in various sectors (public finance, corporates and financial companies, secutirisation activity, etc). In addition, the economic framework and its representation differs in some Member States. The capacity of an enterprise to demonstrate clearly its financial position and executive administrative skills vary from state to state.
Therefore the simultaneous submission of applications would require the same level of supervisory awareness.

2) Do you support the proposed joint assessment process? Does it address the need for efficiency, consistency and reduced administrative burdens in the light of the CRD requirement that each competent authority make its own decision (direct or indirect) on eligibility?

We are generally in agreement with the proposed joint assessment process. However, we have some reservations:

In the first place, we consider that the Supervisor Authorities should be in possession of specialised skills not only in relation to areas of statistics and risk theory, but also in relation to areas of accounting, corporate finance, public finance and financial markets, particularly where these areas meet engineering and informatic methods of application.

A further problem could arise where differing opinions are held by Supervisor Authorities of different States and the decisions to be taken in view of these differing opinions.

With reference to page 5, point 4, how is it possible to reconcile the idea that "...Competent authorities will be able to collect additional information needed to address country-specific issues" when elsewhere the idea of neutrality of rating assessment is expressed?

With reference to page 10, point 32, we consider the regulation regarding an ECAI which provides credit assessment services in several Member States and relative to credit located in one Member State and used by institutions in other Member States as being excessively restrictive in many cases.

A particular issue could arise if an ECAI making application in several member states is refused recognition. What then would be its position with regard to making renewed application?

3) What are your views on the proposed common understanding of the CRD recognition criteria to be implemented by supervisors in determining the eligibility of ECAIs?

Many existing rating methods are based on important inference processes in which the analysis considers data *en bloc*. Following the analysis, the result is extrapolated and is applied to individual entities. In our opinion a significant technical element of judgment is therefore absent. This element represents the recognition of the economic and financial position of each single entity and a rating attribution using actuarial methods which take into consideration its *individual vulnerability* throughout its economic history.

4) What are your views on the proposed approach for implementing the mapping process?

We are in agreement with the general principles regarding the mapping process. We retain, however, that qualitative factors should be organised following engineering and informatic methods of application and should have the capability of transforming qualitative factors in quantitative data.
In order to activate the mapping process, it would be useful to give consideration to the differentiation of the analysis in different market segments.
To have a clear perception of what has already been described it is necessary to consider:

- **the availabily of quantitave and qualitative information**
- **what the concept of default risk adapted is**
- **how we calculate the P.D.**

5) Do you support the proposal that the "mapping" of credit assessments to risk weights should also be addressed under the joint process set out in Part 1 for applications made in more than one Member State?

We support this proposal but only in accordance with the conditions expressed by us in point 2 above, and also reinforced in our response in point 4 above.

6) Do you think that the concept of loss, rather than default probability alone, is the appropriate key parameter for mapping securitisation credit assessments? If not, what should be the appropriate parameter? How should it be measured statistically? To what extent do the same considerations apply for CIU credit assessments?

We operate in a context of finance, risk theory and actuarial mathematics principles. In secutirisation credit assessment we have to adopt discount cash flow analysis using discount rate in compliance with risk. The concept of loss is an accounting category. In the assessment of a credit (in a general sense and also in a problem of secutirisation) the concept of NPV has to be resorted to.
Apart from this consideration the PD is an indispensable concept. In the first stage, the possibility of investigating loss with no recovery rate is essential to understand the vulnerability of the type of general operation. But this means that the concept of PD dominates the concept of loss (expected).
We investigate the PD and the migration matrices following an actuarial method.
Naturally these considerations would also apply to CIU credit assessments.