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**REVIEW OF THE BASEL ACCORD**  
**THE REVISED STANDARDISED APPROACH**  
**AND EXTERNAL CREDIT ASSESSMENT INSTITUTIONS (ECAIS)**  
*Discussion paper*<sup>1</sup>

### INTRODUCTORY REMARKS

The revised “standardised approach” to credit risk, as envisaged by the Basel Committee on Banking Supervision (“the Basel Committee”) will imply an increased use of “credit ratings” (“external credit ratings”) issued by rating market agencies (“External Credit Assessment Institutions” -ECAIs-). Therefore, one of the tasks of the parties involved in the current review of the Basel Accord is to examine, in particular:

- under which conditions these ECAIs could be considered eligible for regulatory purposes;
- how they may be recognised by national supervisory authorities in other countries; and
- to which specific requirements they should be subject in order to ensure a high overall quality of external credit ratings.

Following a brief presentation of the current state of play of the work on the review of the Basel Accord and of the consultation process initiated by the Basel Committee and the European Commission in 1999, the present note identifies some of the main legal issues raised by the use of external credit ratings, especially in the EU context, and in particular:

- the different criteria of eligibility for ECAIs, as identified by the Basel Committee and the European Commission, the latter with regard to the specific EU context;
- the possible options for the recognition of ECAIs by national supervisory authorities; and
- the “mapping” process, i.e. the slotting of the external credit ratings of ECAIs into the risk weighting scales.<sup>2</sup>

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<sup>1</sup> This note and the table attached have been jointly prepared by Stéphane Kerjean and Olga Stavropoulou (Bank of Greece).

<sup>2</sup> Although the present discussion paper also covers the comments expressed by the ECB in May 2001 regarding the review of the Basel Accord, it does not prejudice the future official views which might be expressed by the ECB on the Basel Accord consultation process.

From a general point of view, it is worth considering whether the envisaged regime will require that external credit ratings fulfil high level standards in order to ensure high quality of ratings, thus potentially creating barriers to the entry of new ECAIs in the market, or whether it will encourage penetration in the market of new ECAIs, at the potential expense of the overall rating quality.

It is also important to note that the outcome of the work undertaken in the context of the review of the Basel Accord regarding the specific issue of ECAIs does not prejudice the necessary legal adjustments which will be required in amending the Community legislation in this area.

For the sake of clarity, a table is attached hereto, summarizing the views expressed respectively by the Basel Committee, the European Commission and the ECB in the course of the consultation process on the review of the Basel Accord regarding the use of external credit ratings under the revised standardised approach.

## **I. STATE OF PLAY OF THE DISCUSSIONS ON THE REVIEW OF THE BASEL ACCORD**

### **a. The consultation process launched by the Basel Committee and the European Commission in the context of the review of the Basel Accord**

The EU capital framework, i.e. the provisions on the amount, quality and composition of capital which supervisors require financial institutions to hold in order to cover adequately the risks to which they are exposed, is based to a large extent on the provisions of the 1988 Basel Accord<sup>3</sup>, as amended.

In 1999, the Basel Committee<sup>4</sup> initiated a consultation procedure in order to revise the 1988 framework on regulatory capital requirements and to bring it in line with developments in the financial sector. Following two consultation rounds, and in the light of the numerous comments received with regard to the proposed new regulatory capital regime, the Basel Committee decided to launch a third round of consultations in early 2002. The Committee's aim is to finalise the proposed revisions during 2002 and to implement the new Capital Accord in 2005.

In parallel with the Basel Committee's initiative, the European Commission also initiated, in early 1999, a consultation procedure with the financial industry and other interested parties on the proposed revisions of the current EU capital framework. Also in line with the expressed intention of the Basel Committee to launch a new round of consultations, the European Commission is expected to release a new consultation document in the first quarter of 2002 (possibly in March 2002).

With regard to the content of the consultative documents, the Commission's expressed intention has been not to duplicate the Basel Committee's proposals, but to focus on issues of particular EU concern. The objective of the European Union's legislation on the financial sector is to create global best practice standards for prudential soundness as well as to ensure that there is an international level playing field for financial institutions. In that context, the

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<sup>3</sup> International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision, July 1988, as amended. The 1988 Basel Accord was agreed by the G-10 banking supervisors, which compose the Basel Committee on Banking Supervision.

<sup>4</sup> The Basel Committee consists of representatives of the banking supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Spain, Switzerland, United Kingdom, and the United States. The European Commission and the European Bank participate in observer capacity.

revised EU capital legislation will have to ensure that EU banks and investment firms are able to respond quickly to market change and operate flexibly. It is expected that a proposal for amending the current EU capital framework will be adopted shortly after the finalisation of the revised Capital Accord, expected in September 2002, and that the revised EU regulatory capital regime will enter into force in 2005.

#### **b. The revised Basel Accord and the necessary adaptations of Community legislation**

The European Union's existing legislation on capital requirements needs to be updated to make sure that standards reflect market developments and that capital requirements accurately reflect the risks run by banks and investment firms operating within the EU, while at the same time ensuring no deterioration in the overall levels.

The revised EU legislative framework will comprise two parts, the framework principles (so called "strand one") and the technical rules ("strand two"). With specific regard to the technical rules, it is envisaged to introduce a simplified amendment procedure, in order to render the whole regime more flexible. The revised EU legislative framework will amend the provisions of the "codified" banking directive<sup>5</sup> and/or of the capital adequacy directive<sup>6</sup> related in particular to credit and market risks. In addition to the adoption of the new legislative measures, it is also envisaged to assign existing or new bodies the task to deal with implementation issues, with a view to achieving convergence of national supervisory practices.

## **II. LEGAL ISSUES IDENTIFIED REGARDING THE USE OF ECAIs UNDER THE REVISED STANDARDISED APPROACH**

The approach of both the Basel Committee and the European Commission is based on three "pillars", namely:

- minimum capital requirements;
- a supervisory review process; and
- enhanced market discipline.

With specific regard to minimum regulatory capital requirements, two possible strategies are outlined to ensure that the credit risk of financial transactions is better captured<sup>7</sup> by capital charges. These are (a) a new approach based on the financial **institutions' internal credit assessment systems** and (b) a **revision of the standardised approach by modifying the currently applying credit risk weighting schemes (the "revised standardised approach")**.<sup>8</sup>

It should be mentioned from the outset that the EU new capital framework, which will apply both to credit institutions and investment firms, aims at providing incentives for financial institutions to adopt more sophisticated approaches, in order to allow a closer correlation between the regulatory capital requirements and the underlying economic risk undertaken by

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<sup>5</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (OJ L 126, 26/05/2000, p. 1-59), as amended.

<sup>6</sup> Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (OJ L 141, 11/06/1993, pp. 1-26), as amended.

<sup>7</sup> The aim is to achieve more precise calculations of capital charges on credit risk which, in the case of sophisticated institutions would be quite close or equal to their economic capital calculations for credit risk.

<sup>8</sup> The interaction between the two approaches regarding the use of credit ratings is not addressed in the context of the present discussion paper.

such institutions. In this connection, it is expected that the revised standardised approach will be preferred by financial institutions not wishing to adopt the internal ratings based approach.

In the context of the revised standardised approach, the Basel Committee suggests an increasing recourse to the use of ECAIs.<sup>9</sup> This approach requires to examine to which extent an appropriate legal framework should be put in place, and in particular at the Community level, in order to establish the standards an ECAI must meet for its ratings to be eligible for regulatory purposes. There is also a need to establish a set of strong common standards for both recognition and for the mapping of the ratings into a common scale.<sup>10</sup>

Although, until recent years, the notion of external credit ratings and ECAIs was relatively unfamiliar in the Community legislation<sup>11</sup> and the recourse to credit ratings was limited to certain specific provisions of the capital adequacy directive<sup>12</sup>, these notions have increasingly emerged in the EU context.<sup>13</sup>

With specific regard to the Eurosystem legal framework on monetary policy instruments and procedures<sup>14</sup>, the ECB takes into account available ratings by market agencies in order to assess whether Tier one assets meet high credit standards. They are also used in order to determine the counterparties to the Eurosystem foreign exchange intervention operations and foreign exchange swaps for monetary policy purposes.<sup>15</sup>

It is of interest to note that the European Parliament, in a resolution of 17 November 2000 on the review of the Basel Capital Accord<sup>16</sup>, emphasised the importance of establishing a framework to “rate the raters”, setting out minimum criteria for the accreditation of ECAIs to ensure their credibility and transparency.

#### a. The eligibility criteria for ECAIs

According to the proposals of the Basel Committee, an ECAI should satisfy the following criteria in order to become eligible for regulatory purposes:<sup>17</sup>

- **Objectivity:** the ECAI’s assessment methodology should be rigorous, systematic and subject to some form of validation based on historical experience. Inter alia, the ECAI should establish track records of at least one and preferably three years.
- **Independence:** the ECAI must be independent from political or economic pressure and must be free of constraints which could arise in situations where the composition of the

<sup>9</sup> It must, however, be noted that there is no requirement for any financial institution, either credit institution or investment firm, or any counterparty to these institutions, to obtain an external credit rating.

<sup>10</sup> See the attached Table.

<sup>11</sup> An exception in this respect is the area of EU competition law, where the European Commission often refers to credit ratings issued by rating agencies, in particular in its assessment of the compatibility with the Internal Market of State aid granted to credit institutions. For interesting developments of this issue, see the complaint lodged by the European Banking Federation with regard to the explicit support mechanism granted by the German authorities to the German public sector financial institutions (and the Commission press release of 17 July 2001 (IP/01/007)).

<sup>12</sup> See Art. 2 (12), which refers to credit rating agencies in the context of the definition of “qualifying items”.

<sup>13</sup> See for instance Article 6(2) of the proposal for a Directive of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) adopted by the Commission on 30 May 2001, EC OJ of 28.08.2001, C 240E/265.

<sup>14</sup> See Chapter 6 of the General Documentation which forms Annex 1 of the Guideline of the ECB on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7, OJ L 310 11/12/2000 p. 1).

<sup>15</sup> See Annex 3 of the General Documentation.

<sup>16</sup> See EC OJ C 223/361, 08.08.2001.

<sup>17</sup> The initial proposal envisaged seven criteria, one of them being that the ECAI should be granted recognition by the competent supervisory authorities. The recognition criterion was, however, deleted from the list of criteria in the second consultative document released by the Basel Committee in 2001. The recognition process is dealt with separately from the ECAI eligibility criteria, both in the context of the Basel Committee’s proposals, and in the context of the European Commission’s assessment.

board of directors or the shareholder structure of the ECAI may be seen as creating a conflict of interest.

- **International access/Transparency:** the individual assessments should be available to both domestic and foreign institutions with legitimate interests on an equal basis. The general methodology used by the ECAI should be made publicly available.
- **Disclosure:** disclosure of information of both a qualitative and a quantitative nature is seen as a necessary prerequisite to ensure that assessments are effected by reputable ECAIs. Transparency in this context constitutes a safeguard against financial institutions “assessment shopping” for ECAIs, which may grant more favourable assessments, which, ultimately, may lead to inadequate capital charges.
- **Resources:** resources of an ECAI should allow in particular for regular contact with senior and operational levels within the entity assessed. Assessments should be based on methodologies combining qualitative and quantitative aspects.
- **Credibility:** the credibility of an ECAI is to a large extent based on the fulfilment of the criteria mentioned above. The reliance on an ECAI’s assessment by independent parties such as investors, insurers and trading partners, as well as the existence of internal procedures to prevent abuse of confidential information constitute evidence of credibility.

As mentioned in its first consultative paper, the European Commission focuses on the two core criteria, which should be fulfilled in order for an ECAI to receive regulatory recognition, i.e. **credibility and transparency**. The Commission was, at least at that time, of the view that the criteria laid down in the Basel Committee’s consultative documents are essentially subsets of credibility and transparency.

In its comments on the review of the Basel Accord, the ECB stated that an overall high quality of ratings should be ensured. As regards the proposed eligibility criteria, further emphasis should be placed on the credibility requirement. As far as the objectivity criterion is concerned, the ECB is of the opinion that it would be preferable to focus on rating methodology and rating processes rather than on the minimum time period of track records. The ECB also recommended that some practical guidance be given on the implementation of the resources criterion, and that comparability of rating scales be added in the overall list of the eligibility criteria.

## **b. The recognition process for ECAIs**

Both the Basel Committee and the European Commission adopt the view that the recognition of eligible ECAIs in the regulatory context should fall within the responsibilities of the national competent authorities. Banking supervisors will hence play a critical role in this validation process. A general concern is the implementation of the recognition criteria on a country-by-country basis. In particular, concerns have been expressed, especially by credit institutions, on the way in which supervisors will exercise their judgement in applying and interpreting the criteria, and on the risk of inconsistent interpretation and application across countries which would harm the level playing field.

According to the Basel Committee proposals, it is suggested to grant to the national supervisory authorities full discretion in assessing the eligibility of an ECAI. It has been further proposed that the Secretariat to the Basel Committee will serve as a clearing house of information on the ECAIs recognised by national supervisory authorities. However, it should be borne in mind that the implementation of the Basel Committee’s proposals is based on

mutual agreement and understanding and are not legally binding and enforceable, as it is in the EU context.

The European Commission envisages two alternative scenarios, which are considered to be more appropriate in the EU context:

- **Full recognition:** under the full recognition scenario, the supervisory authorities of a Member State shall be obliged to accept the recognition of ECAIs made by other Member States, in respect of rated exposures in the Member State which recognised the ECAI.
- **Bounded recognition:** under the second option, the supervisory authorities of a Member State are entitled to refuse recognition of an ECAI which has been recognised by another Member State. Similarly, a Member State may recognise an ECAI recognised by another Member State, without having to undertake an independent assessment. The latter option grants Member States the right to apply more stringent rules with regard to the recognition process, on a domestic basis.

It should be mentioned that, according to the Commission, in either case, the Member State would have to arrive at its own judgement on whether to recognise ECAI assessments for exposures or entities located in a third country.<sup>18</sup>

The discussions on the recognition process highlight the difficulties encountered by the parties involved in the consultation procedure to reach a consensus on such issues as the requirements which must be imposed on ECAIs in order to be granted recognition, the need to ensure a level playing field within the EU and the need to avoid creating artificial barriers to entry of new ECAIs to the credit rating market.<sup>19</sup>

### c. Other related issues

Other issues which also deserve further analysis from a supervisory and regulatory point of view are (i) the mapping process, and (ii) multiple assessments.

#### i. Mapping

According to the approach adopted by both the Basel Committee and the European Commission, the slotting of the credit assessment categories into the risk weighting scales (known as “mapping”) is a task to be assigned to national supervisory authorities. However, the Basel Committee is carrying out a mapping exercise with a view to providing assistance to the competent authorities.

Consistency of approaches between jurisdictions is of particular significance in the EU context. Taking into account the fact that mapping would be performed by national supervisors, the European Commission is particularly interested in determining the extent to which there will be a need for harmonisation of the mapping process itself to ensure consistent high standards throughout the EU.

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<sup>18</sup> At this stage of the consultation process, it is noted that the European Commission sought the views of interested parties on certain issues. With specific regard to the proposed revisions on the standardised approach, the Commission requested interested parties to indicate, among other (a) whether they would support the proposals put forward by the Basel Committee regarding the revised standardised approach and, if there are elements of the proposals that they do not support, to provide specific details, and (b) which of the two options in respect of the recognition of ECAIs (full recognition vs bounded recognition) they would favour.

<sup>19</sup> Potential creation of barriers to entry is an issue which could also be examined in the light of European competition rules.

According to the proposals, financial institutions are required to use the ECAIs they have opted for as well as their respective credit ratings consistently, i.e. they will not be allowed to “cherry pick” among the ratings provided by different ECAIs.

ii. Multiple assessments

Divergent views have emerged in the context of the treatment of multiple assessments, i.e. in order to determine which assessment will be used for the calculation of capital charges: the Basel Committee proposes to use the second best assessment, whereas the European Commission has so far opted for the lowest rating.

**The present paper is submitted for discussion to the EFMLG Members. Members are invited to provide the views of the banking industry concerning the establishment of a sound legal framework applicable to ECAIs, as currently discussed in the context of the review of the Basel Accord.**<sup>20</sup>

**Encl.**

**Table:** *External Credit Assessment Institutions in the context of the revised standardised approach proposed in the new Basel Capital Accord:* presentation of the views expressed by the Basel Committee, the European Commission and the ECB.

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<sup>20</sup> It is noted that the US framework applicable to rating agencies as well as the comments of interested parties regarding the issue of rating agencies in the context of the review of the Basle Accord may give rise to further analysis at a later stage.