OFFICIAL INFORMATION
OF THE CZECH NATIONAL BANK

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regarding the prudential rules for banks, credit unions and investment firms

Methodology and Credit Assessments of Rating Agencies

The Czech National Bank hereby provides the following information with regard to Articles 122, 123, 125 and 126 of Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms:

I. The requirement for the objectivity of the rating agency's methodology is understood as follows:

1. The rating agency's methodology is rigorous and systematic if it takes into account all the relevant factors influencing the obligor's creditworthiness, which is backed up by, in particular, quantitative statistical evidence of the methodology's differentiation (discrimination) ability (e.g. default statistics for individual rating grades and transition matrices).
2. The rating agency's methodology is consistent if two entities with the same creditworthiness receive the same external rating regardless of who assesses them. The methodology is verified (validated) on the basis of allocated credit assessments over time and for individual market segments. In cases where less satisfactory quantitative evidence is available, the Czech National Bank's (CNB) assessment shall concentrate primarily on the actual process of credit assessment (inputs).

II. The requirement for the independence of the rating agency's methodology is understood as follows:

1. The rating agency has drawn up procedures ensuring that the allocated external ratings are under all circumstances independent and objective and ensuring that there are no conflicts of interests. The following situations, in particular, are regarded as a conflict of interests:
   a) the rating agency is owned by the government, a chamber of commerce or political body that has an interest in ensuring favourable external ratings for entities it has established;
   b) the rating agency, its owner or employee has a private or personal interest in a rating on the grounds of a personal or property connection to the entity receiving the rating;
   c) the rating agency's financial situation depends on income from key customers that could abuse their position to ensure favourable external ratings;
   d) the rating agency provides ancillary services to the assessed entities or has other commercial relations with them that might compromise the objectivity of the external ratings;
   e) an employee of the rating agency holds a managerial position in an assessed entity;
   f) employees of the rating agency are assessed and remunerated in a manner that could result in unobjective external ratings.

2. The rating agency has proposed and introduced internal procedures, a pricing policy, methods and procedures for staff management, a code of ethics and a governance in a way that manages potential conflicts of interests and ensures that allocated external ratings are not influenced by economic and political pressure. It is expected that the rating agency
   a) has appropriate procedures ensuring the independence of allocated external ratings;
   b) has an organisational structure separating operational, personnel and possibly also legal activities associated with the provision of external credit assessments from any other activities and areas of business of the rating agency;
   c) has sufficient financial resources and procedures preventing it from becoming dependent on key customers and issuers;
   d) has employees who are sufficiently qualified (e.g. at least one person involved in decision-making on allocated external ratings has at least a three years' experience in rating or credit analysis);
   e) has an independent internal audit unit; and
   f) has written internal procedures and rules of governance.

3. The rating agency makes the mechanisms used to identify, manage and eliminate conflicts of interests publicly available.

III. The requirement for ongoing review of the rating agency's methodology is understood as follows:

1. Allocated external ratings remain up-to-date even if market conditions change. A significant event is an event that could potentially or actually result in a change to an allocated external rating (rating grade).

2. The rating agency has procedures that ensure that external ratings are subject to ongoing review, and in particular
   a) reliably detect changes in the conditions to which the assessed entity is subject and which could potentially influence a change in the allocated rating grade;
   b) ensure that the rating grade is genuinely adjusted if the changes are so significant that they necessitate an adjustment;
   c) has an overview of how rating grades are reviewed, including contacts with the assessed entities.

3. 'Back-testing' of external ratings means analysis of external ratings provided in the past. Most notably, this means the ability to prove that a better external rating grade is associated with a relatively lower probability of default or a lower loss rate. Back-testing should work on the basis of external ratings defined over the longest possible period of time and from the largest possible number of assessment cases. Back-testing must be proven separately for every market segment that is required to be entered to the list.

4. A substantial change to a rating agency's methodology is any change resulting in a change to allocated external ratings.

IV. The requirement for the transparency of the rating agency's methodology is understood as follows:

The rating agency itself chooses the form, format and scope in which it makes information publicly available. The information made publicly available must include sufficiently comprehensible principles of the methodology used by the rating agency. The information must be accessible to the broadest possible range of users, including the expert public (e.g. free-of-charge website). The rating agency updates the published methodology principles as soon as possible after an update of the methodology is approved.

V. The requirement for the credibility of the rating agency's methodology is understood as follows:

1. Credibility always applies to a market segment which is required to be entered to the list. Besides the general acceptance of ratings in the capital or financial markets, other factors confirming the rating agency's credibility and market acceptance may also be considered (e.g. the fact that a substantial number of liable entities intend to use the given rating agency's external ratings to calculate capital requirements; mentions in the media; ways in which allocated external ratings are used in the market etc.).

2. In the case of securitisation, the rating agency's credibility and market acceptance is particularly important, most notably the fact whether the rating agency has sufficient experience with allocating external ratings to securitised positions.

VI. The requirement for the external rating's transparency is understood as follows:

1. Equivalent terms of access to individual external ratings are terms whereby under equal economic assumptions there is no unjustified discrimination (e.g. price discrimination) between parties that have a legitimate interest in using external ratings. Equivalent terms need not be identical terms.

2. From the point of view of time, equivalent terms are such terms whereby all external ratings are accessible at the same time and are updated immediately after a new external rating is allocated or an already allocated external rating is updated (changed)
   a) for all parties if the rating agency does not charge subscribers for access to external ratings,
   b) for all subscribers with paid access to external ratings for the given market segments.

VII. Long-term default rates are understood as follows:

1. The "cumulative" default rate for a period of three years, calculated as the sum of all defaults in the given three-year period for all entities with an external rating in the given rating grade, is regarded as the principal variable attesting to long-term default rates. The rating agency has a ten-year average of three-year cumulative default rates available, as well as the two most recent three-year cumulative default rates. After entering the rating agency to the list of agencies for credit assessment the CNB constantly monitors the two most recent three-year cumulative default rates.

2. A rating agency that does not have a long history or has not yet collected default data for a sufficiently long period of time has, in particular, the two most recent three-year cumulative default rates and a projection of the ten-year average of three-year cumulative default rates available. In the event of an insufficiently long history of default data, it is possible to take into account sufficient qualitative factors contained in the rating agency's methodology compared to the methodologies of rating agencies used for benchmarks for long-term default rates (see Point 3 below), and in particular
   a) the definition of default;

b) the set of assessed entities;
c) the statistical significance of default rates;
d) the significance (definition) of an external rating represented by a specific grade;
e) the method of weighting events of default;
f) geographical coverage;
g) dynamic properties of the rating system.

3. Benchmarks for the long-term average of three-year cumulative default rates

Comparable Standard and Poor's (Moody's) rating grade	AAA – AA (Aaa – Aa)	A (A)	BBB (Baa)	BB (Ba)	B (B)
Value of long-term average of three-year cumulative default rates	0.10 %	0.25 %	1.00 %	7.50 %	20.00 %

4. Benchmarks for cumulative default rates for a period of three years

Comparable Standard and Poor's (Moody's) rating grade	AAA – AA (Aaa – Aa)	A (A)	BBB (Baa)	BB (Ba)	B (B)
Monitoring value	0.8 %	1.0 %	2.4 %	11.0 %	28.6 %
Warning value	1.2 %	1.3 %	3.0 %	12.4 %	35.0 %

VIII. The significance of quantitative and qualitative factors for mapping external rating grades to credit quality steps is understood as follows:

Quantitative factors are the initial factor used for mapping, but qualitative factors influencing the value of quantitative factors are also taken into account, e.g. the definition of default or the deterioration of an exposure or an obligor, information from the market, the degree to which rating agencies' published external ratings are viewed as mutually similar, access to the processing of external ratings performance statistics (cohort-based or based on the original rating), access to revoked external ratings and to cases that ceased to be in a state of default, access to the processing of seasonality and the economic cycle, the significance (definition) of an external rating represented by a specific grade.

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