CNB CZECH NATIONAL BANK

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EC Public Consultation:

Credit Rating Agencies

Opinion of the Czech National Bank

General

The Czech National Bank has long been monitoring the area of external ratings. Our opinion is based on the fact that external ratings are a product that originated on the market naturally, without the effect of regulation. They are therefore long standing, desired and verified by the market. Despite all their pitfalls, market participants, issuers, investors and others have become accustomed to them and use them for various purposes. Ratings started to be used for regulatory purposes only later, i.e. long after they came into existence, and this application of ratings can be regarded as non-market use. By definition, ratings cannot be considered investment recommendations. They are merely opinions concerning the relative probability of default of an issuer or issue. Not only are these opinions based on the assessment of historical data (on the debtor, the industry, etc.), but they also contain certain assumptions regarding the future that may materialise to a greater or lesser extent, as well as a great deal of expert judgement. Therefore, they cannot be considered deterministic; they merely represent the most probable future scenario in a particular area (in this case credit risk, but not, for example, market risk) and for a certain time horizon. If ratings are not part of the regulations, market participants may choose either to use them or not to use them.

With regard to ratings, the Czech National Bank has long had a general preference for solutions that are based on the natural properties of the market and do not cause further market distortions that are difficult to rectify later on. The introduction of ratings into regulations and the recent search for ways to eliminate them are an example of this procedure. We therefore support increased disclosure in the ratings area, for example as regards rating methodologies and providing the market with as much information as possible on the meaning and limitations of ratings. We are against excessive and ill-considered regulatory intervention and the involvement of the state and public funds in issuing ratings.

Opinions on, and answers to, individual groups of questions

Questions 1-6:
(1) Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?
(2) How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?

(3) Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?
(4) What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?
(5) Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed? To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?
(6) Can the existing "supervisory formula" based approach in the Capital Requirements Directive be considered to be sufficiently risk sensitive to become the standard for all securitisation capital requirements? If not, how could its risk sensitivity be improved without placing reliance on institutions' internal estimates other than default probability and loss for the underlying exposures? In the insurance sector, how do you assess the approach to credit risk for structured exposures used in QIS 5?

CNB opinion:

In our experience, there is no need to limit the use of standardised approaches to smaller firms by regulation, as this is a natural tendency. The direct imposition of an obligation for large, "sophisticated" firms to use their own, non-rating-based assessments could be very costly and inefficient for such firms if their exposures to instruments requiring a rating are low.
We assess the reliability of internal models for regulatory purposes which are subject to validation and regular inspection as good. However, regulated institutions also use other – usually partial – models in their internal risk management that are not validated by the supervisory authority to the same extent, as they are not used for regulatory purposes. In the case of these models, compliance with risk management principles is checked during inspections. In general, however, model risk should be taken into account for every model.
We disagree with introducing a requirement to use two ratings only for compliance with the regulatory duty in the case of capital requirements. However, if more ratings are available, their use can be considered more prudent. It is also admissible that an exposure with only one rating will be regarded as an unrated exposure (analogously to Basel I).
Alternative measures of credit risk do not appear usable for regulatory purposes (for example, they are not available for all issues or issuers and they may have an insufficient information value if liquidity is low). The regulatory solution could be a combination of external ratings and market indicators of credit risk defined by a regulatory scale. However, this option needs to be explored further. It would basically represent an elaboration of Market Implied Ratings (which have already been introduced by some rating agencies). Market signals usually respond faster than external ratings and give rise to procyclicality. Moving averages could be used to dampen procyclicality, but there is a clear trade-off: the longer the reference period, the more limited the information value in relation to the monitored entity's current credit assessment. Therefore, even a return to non-risk-sensitive capital requirements (e.g. analogously to Basel I), which are not procyclical, can be regarded as an alternative. However, we wish to emphasise that there is a need to unambiguously select the objective that the regulation is to pursue (risk sensitivity versus risk non-sensitivity). We note that the

aim of Basel II that has also been supported by the CNB was to increase the risk sensitivity of the framework. This was successfully achieved, among other things, by introducing ratings into the regulations.
Generally, it is already true that a regulated institution should invest only in products (instruments) which it understands and for which it knows how to assess, monitor and manage the related risks. If the risks are not sufficiently covered by the minimum capital requirement, the regulated institution must account for this in its internal capital. We consider it excessive and too restrictive to explicitly restrict the investment base for securitisations for which capital requirements can be reliably assessed using internal ratings of the underlying exposures.
We have no comments on the approaches used in the insurance sector in QIS 5.

Questions 7-11:
(7) Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?
(8) What information should be disclosed to supervisors in order to enable them to monitor the internal risk management processes of firms with particular focus on the use of external credit ratings in these processes?
(9) To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in thein investment policies, risk management processes and in investment mandates?
(10) What further measures, in addition to the disclosure proposals included in Articles 8a and 8b of the proposal amending the current CRA Regulation could be envisaged?
(11) Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?

CNB opinion:

We agree that firms (regulated institutions) should carry out their own assessments of the financial condition of counterparties/securities issuers and should not rely fully on the ratings issued by rating agencies, except in the case of insignificant exposures. Internal risk management processes should always correspond to the significance of the exposures concerned and the degree of risk undertaken.

Credit risk models are being used increasingly. They are most widespread among banks and insurance companies. They are generally used mainly by large financial institutions and subsidiaries of large financial institutions or financial groups, as they are demanding in terms of cost, expertise and data. However, the use of credit risk models does not pertain to portfolios of marginal significance, where it would constitute too large a burden. The involvement of senior management in internal risk management processes is one of the requirements.
Disclosure of information on structured securities should not be restricted by any conditions and should be available to the broadest possible range of market participants. This leads to greater market transparency, allows ratings to be obtained from other rating agencies and not just from the hired agency, and enables internal financial analyses to be carried out even in small financial institutions.

Sovereign debt ratings are primarily based on publicly available data. However, not all financial institutions (especially small ones) have sufficient resources to be able to perform reliable assessments of sovereign risk, as this is a demanding activity. Therefore, there is no sense in requiring internal assessments of sovereign risk where the financial institution's exposure is insignificant.

Questions 12-15:

(12) Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?
(13) Should investment managers be obliged to introduce measures to ensure that the proportion of portfolios that is solely reliant on external credit ratings is limited? If yes, what limitations could be considered appropriate? Should such limitation be phased in over time?
(14) What alternative measures of credit risk could be used to define the minimum standard of credit quality for a portfolio? Are rolling averages of bond prices/CDS spreads a suitable risk measure for this purpose?
(15) What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates?

CNB opinion:

In general, we are against the idea to introduce a "flexibility clause" into investment mandates or policies. In our opinion, this option is a matter for contractual relationships between clients and investment managers. Mandatory introduction could harm clients. For the same reasons, we do not support the introduction of an obligation to reduce the reliance of portfolios on external ratings.
We regard monitoring of spreads vis-à-vis a reference instrument/benchmark and rolling averages of bond prices as suitable additional indicators complementing external ratings. However, internal risk assessments are of key importance. The UCITS IV Directive already contains a requirement to analyse the economic benefits of trades and draw up a forecast of how the investment will affect the asset structure, liquidity and risk profile of a collective investment fund.

Questions 16-18:

(16) What is your opinion regarding the ideas outlined above? How can the transparency and monitoring of sovereign debt ratings be improved?
(17) Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?
(18) Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?

CNB opinion:

We consider it inappropriate to introduce a requirement to inform the relevant country at least three days ahead of the publication of a rating. Although such a requirement would make it possible to correct factual mistakes, there is a risk of market abuse. We consider it more important to impose a requirement to consult the relevant data with the government in

advance, i.e. during the rating process, not at the end. It is vital that all information processed using a publicly disclosed methodology is up-to-date and undistorted. This also applies to data issuers. We consider it inappropriate to have a direct requirement for a specific shortening of the time period for rating reviews (as expressed by the length of the time period). We recommend replacing it with a qualitative requirement that a review should be conducted almost immediately after fundamental (i.e. surprising or unexpected) data are published.
Increased transparency of the rating process can be viewed as a justified and reasonable requirement. It could be fostered by requiring rating agencies to publish (i) the detailed methodology used by the agency for its sovereign debt ratings, and (ii) a detailed report for each individual rating on how this methodology was implemented, using specific figures. This procedure would undoubtedly give rating users a better understanding of the reasons for, and timing of, specific rating actions, and thus would contribute to their better awareness. Nevertheless, the decision regarding the fee charged for a detailed report on a particular rating should be left to the agency.
Increased transparency of sovereign debt, and therefore of sovereign debt ratings as well, could be fostered by a better level of disclosure of public finance accounts (e.g. publication in clear tables in a single location and in accordance with a consistent methodology). This idea is also currently being developed by CESR.

Questions 19-22:
(19) What is your opinion on the need to introduce one or more the proposed measures?
(20) More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?
(21) Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?
(22) What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

CNB opinion:

Rating agencies are already required to publish their methodologies, models and key assumptions. We believe that a requirement to publish even more detailed explanations of the assumptions, parameters, limitations and uncertainties relating to sovereign debt rating models and methodologies will lead to a further reduction in the problem of information asymmetry on sovereign debt markets and will increase the credibility of the rating process. We do not consider the proposals for a new duty to organise regular (biannual) methodology meetings to be appropriate. Rating agencies hold similar meetings voluntarily where the need arises. However, the obligatory establishment of a mailbox for methodology inquiries and the disclosure of questions and answers on a website can be regarded as a step towards increasing the transparency of ratings, as websites are available to anyone at any time. Moreover, the inquirers' suggestions may contribute to market pressure to improve rating methodologies.
According to the regulatory requirements, ratings should be published on an unselective basis and in real time. We disagree with the idea of introducing a regulatory duty to publish ratings after the close of business in Europe. We believe that it is illogical to regulate the time of publication solely in relation to business in the EU and that the decision should be left to the rating agency. Analogously, it would be possible to require agencies to publish ratings after the close of business in the USA, Australia, etc. We also believe that new ratings do not provide particularly surprising fundamental information that might spread asymmetrically on

the market. We do not support obligatory individual consultations between rating agencies and the particular state on the time of publication of ratings, as this would represent a form of manipulation of ratings.
As regards paying rating agencies for rating government bonds, we believe that such ratings if they are unsolicited should not be paid for. However, we support unification of this practice by rating agencies in general, not only in the EU.

Questions 23-30:
(23) How could new players be encouraged to enter the credit rating agency sector?
(24) Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions? If yes, which asset classes (corporate, sovereign, structured finance instruments etc) could be considered?
(25) Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?
(26) Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level? How could such agencies be structured and funded and what entities and products should they rate? What are the potential advantages and disadvantages of this approach?
(27) Is there a need to create a new independent European Credit Rating Agency? If so, how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit rating agency? What are the potential advantages and disadvantages of this approach?
(28) Is further intervention needed to lower barriers to entry or expansion in the credit rating agency sector in general or as regards specific segments of the credit ratings business? What actions could be envisaged at EU and at Member State level?
(29) Would the creation of a European Network of Small and Medium Sized Credit Rating Agencies help increase competition in the credit rating agency sector? What are the potential advantages and disadvantages of this approach?
(30) Do you consider that there are any further measures that could be adopted to enhance competition in the rating business?

CNB opinion:

The current number of naturally established rating agencies is sufficient to serve the market. A sufficient number of entities have expressed an interest in registering rating agencies under the relevant EU regulation.[1] We therefore fundamentally oppose the creation of a European Credit Rating Agency or any other agencies, especially publicly subsidised ones. It would not be possible to view such agencies as competitive and independent. What is more, such agencies cannot enforce market acceptance. We also strongly believe that regulation of rating agencies should not be increased further unnecessarily, thereby creating further, artificial barriers for potential new entities (i.e. natural competition). Imposing measures to create new agencies would be a pointless waste of public money.

[1] More than 20, according to our information.

Ratings issued by the ECB or national central banks could suffer from many shortcomings (reputational risk, conflicts of interest arising from the central bank's securities trading, the parallel role of the central bank as supervisory authority). This could lead, among other things, to the tolerance of errors if such errors arose in a regulated institution due to a bad rating. However, if central banks were to produce such ratings at their own discretion, their ratings should be subject analogously to the rules that apply to private ratings, including the publication of detailed methodologies. We would consider it beneficial to market participants if the current haircut creation process used by the ECB was made more transparent and such haircuts were explicitly linked to issuers' economic fundamentals, without the need to create a new rating system.

<u>Questions 31-33:</u>

(31) Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?
(32) If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?
(33) Should such a potential liability regime cover solicited as well as unsolicited ratings?

CNB opinion:

We see no reason to unify the principles of civil liability in the EU. On the contrary, we are afraid that more restrictive civil liability principles would lead to a lack of interest in providing public ratings or to the production of ratings with a lower information content. Moreover, increasing the liability of agencies might send out a misleading signal to investors that they do not need to conduct their own assessments of invested funds and that they can transfer their bad decisions to rating agencies not only morally, but also legally. This proposal is thus in direct conflict with the proposals to strengthen internal risk management, which can be considered crucial, especially in respect of institutional investors. It must therefore be opposed.

<u>Questions 34-36:</u>

(34) Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?
(35) What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the "issuer-pays" model? If so please indicate which alternatives appear to be the most feasible ones and why.
(36) Are there any other alternatives to be considered? If so please explain.

CNB opinion:

We consider the current prevailing "issuer-pays" model to be less than ideal, but it is the best option available. The other models are not free of conflicts of interest either; these conflicts are just different in nature. We could accept the "investor-pays" model (this model is already operating to some extent, e.g. fees for accessing detailed information on rating agencies' websites) or the "trading-venue-pays" model if this is also acceptable to the market. If the Commission wishes to develop alternative models and present them to the market, we recommend focusing on the "trading-venue-pays" model, which currently, paradoxically, has the briefest description in the Commission proposal, or on some other similar "investor-pays" model. We fundamentally oppose the proposed "payment-upon-results" model and the

“government-as-hiring-agent” and “public-utility” models. These models are of an entirely non-market nature, introduce further market distortions and conflicts of interest, and increase public budget expenditure.

Question:
(37) Are there any other issues that you consider should be tackled in the forthcoming review of the CRA Regulation?

CNB opinion:

No.