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Submitted electronically

European Banking Authority
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United Kingdom

Draft Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)

Dear Sir / Madam

Please find enclosed AFME's response to the Draft Implementing Technical Standards On the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation—CRR). Should you have any questions or desire additional information, please do not hesitate to contact us.

Yours sincerely



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AFME

Consultation response

Draft Implementing Technical Standards on the mapping of ECAI's credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)

18 June 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **INSERT NAME OF CONSULTATION PAPER**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Introduction

AFME is broadly supportive of the objectives of this ITS and we understand the need for consistency in the minimum standards and the need for uniformity in the logic of the calibration methodology. However, without the publication of the mapping tables for Annex III of the ITS, it is impossible for us to comment fully on the proposed methodology and on the impact on firms, whose capital requirements will reflect the result of the proposals. Furthermore, firms will require sufficient notice of changes to make the necessary changes to their systems and therefore suitable transitional arrangements need to be put in place.

As regards the appropriateness of the proposed approach, ECAIs apply a range of quantitative and qualitative methods depending on the credit assessments they perform on a variety of debt-like instruments or exposures. The rating methodologies must be appropriate to a variety of portfolios, their respective materiality, as well as the granularity and length of available time series of data. We do believe that to achieve the goals of comparability and consistency there is a need for guidance on the typical steps and quality standard of the ECAI mapping process, rather than for over prescriptive methodology. A very prescriptive methodology is likely to be

inappropriate for certain markets and sectors at any point in time and may lead to unintended consequences.

We would rather empathize with monitoring and back-testing processes as major control elements for consistency and adequacy of mappings defined by ECAI's. In this context, we highlight that the modelling principles, especially regarding time horizons, are good as guidelines but should not be converted into strict rules. The requirements on quantitative factors are ignoring specificities pertaining to each ECAI's business model or mission statement, the risk profile of the pool of issuers that the ECAI covers, its geographical footprint and available data history. So while preserving the objective of reducing differences stemming from purely methodological aspects, it is important to keep open the range of practices when their appropriateness is duly demonstrated.

As an example:

In case of LDP a 3-year time horizon for short-run default rates calculation may not prove relevant; it could possibly make more sense to calculate directly a long-run default rate based on a longer than 3 year observation period.

- The definition of "recessionary period": Experiences are highly dependent on the geographies and industries covered in the portfolios.

Finally, we believe that the aim of the ITS should be to define qualitatively – and not limit quantitatively - the drivers to be considered in the mapping process (for example short/long run default rates, integration of recession effects, demonstration of statistical soundness of samples used and appropriateness of margin of prudence applied, etc.).

Questions

Q1. Do you agree with the proposed selection of quantitative factors to differentiate between the different levels of risk of each rating category?

We have the following comments on the overall approach:

- With regards to point 11, we believe that if the objective is to make comparisons across ECAIs "when risk is very low" then a period greater than 3 years should be used. ECAI grades from AAA to AA would qualify as "very low risk", but rarely contain default events.
- In fact, the length of the period should be defined by the ECAI which should demonstrate that the chosen length (3 or more years) is adjusted to the frequency of defaults observed within the rating grade.
- It must be noted that rating migration should be considered with a particular attention in case of a multi-year observation period is used to observe and calibrate default rate at a rating grade.
- Point 19 – If the default rate breaches the benchmark, we believe that action should be taken within 2 years. If the default rate is being assessed over a rolling 6 month cohort then the breaches can be evidenced before the 2 year period is up. However, the underlying issue is the economic cycle when the default observations are made and that consideration needs to be given to the fact that default rates fluctuate during the cycle.
- Article 2(a) – Our members believe that the items should not be limited to "Corporates" only. We recommend that all observations should be used, based on the fact that ECAI's ratings are equivalent across the sectors (e.g. Corp AAA = Banks AAA = Sovereign AAA).

Q2. Do you agree with the proposed definition of sufficient number of credit ratings and rest of requirements imposed to the calculation of the short run default rate when a sufficient number of credit ratings is available?

- Article 3 (2) – Similarly to our comment regarding Point 19 above under Q1, AFME members believe that a period longer than 3 years should be used.
- Article 4 (b) – Further clarity is required on the quantification of “sufficiently numerous”
- Article 5 – The article proposes to count withdrawn ratings at 50% in the denominator. AFME believes that if there are grounds to think that the ratings were withdrawn due to imminent default, they should be considered as defaults. This would imply that the withdrawal should count at 100% in the numerator. Additionally, more clarity is sought why 50% has been chosen for the calculation. We recommend a more accurate weighing methodology to better reflect when in the observation period the withdrawal was made.

Q3. Do you agree with the proposed requirements imposed to the calculation of the long run default rate when a sufficient number of credit ratings is available?

AFME believes that there should be a principle that guides the firm specific methodologies rather than a closed approach such as proposed in this ITS (short-run equals 3 years, long-run equals 10 H years).

The industry proposes that the guideline should state: “a short-run and a long-run default rate must be calculated. The time horizons and length of data used for calibration must lead to statistically strong results. If the data quality is poor or the history is short, then the portfolio segmentation and other risk drivers should be adjusted so to adapt the granularity of the calibration to the objective of robustness. Finally a fully documented use of expert judgment and rationale can complement the calibration process if there is a need for management adjustment of calculation output.”

Q4. Do you agree with the proposed options to calculate the quantitative factors when a sufficient number of credit ratings is not available?

The method for calibration of the default rate by the ECAI and in particular the suggested rule to assess the minimum size of the pool used for calculation of the default rate should not be limited to the unique approach “*number of rated items to be greater or equal to the inverse of the expected long-run default rate*”. In this particular case various approaches are possible and should be allowed, such as:

- Bayesian inference to take properly into account the prior estimate (“expected long-run default rate”) and the observed distribution;
- Monte Carlo simulations or boot-strapping to calculate proper confidence intervals around values in the available data history.

Q8. Do you agree with the proposed use of the risk profile of a rating category as a relevant factor for the mapping?

- Article 12 – We believe that the minimum standard for assigning creditworthiness should not be limited to just size, sector and geography. AFME believes that the metrics for size should be better defined and that historical and projected financial performance should also be considered.

Q10. Do you agree with the proposed use of the internal mapping of a rating category established by the ECAI?

We would like to confirm that the internal mapping for specialised ratings, such as short US municipal ratings, would also be captured by this provision.

Q11. Do you agree with the proposed specification of the long run and short run benchmarks? Do you agree with the proposed mechanism to identify a weakening of assessment standards?

- On back testing and monitoring of the mapping breach, we believe that the principal objective of the ITS should state: “an objective breach-criteria (for example default rates breaching the benchmark by a magnitude that is material in the context of the firm’s own portfolios and over a notably long and stable period) must be defined by the institution. The mapping must be back-tested regularly against the breach-criteria as described in the regulatory approval process.
- Regarding the formula for confidence interval, we understand that it’s a binomial confidence interval. However, we recommend that the EBA seeks for a more robust approach than the addition of two defaults to the populations. This methodology will lead to higher tolerances for the strongest rating categories which seems inappropriate.

Q12. Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or which might further inform our analysis of the likely impacts of the proposals?

We agree with paragraph 34 of the Cost Benefit Analysis that the main impact of this regulation will be that on the capital requirements of banks. We would note that the impact will not be confined to the standardised approach, since ratings are used in other parts of the regulatory framework – for example the ratings based approach for securitisation, collateral and guarantor eligibility and large exposures exemptions.

Without the publication of the associated mapping tables, it is therefore impossible for us to comment on the impact of the draft ITS.