JOINT COMMITTEE OF THE EUROPEAN SUPERVISORY AUTHORITIES

<table>
<tr><td colspan="2">Comments on EBA, EIOPA and ESMA joint Cobsultaion Paper JC-CP-2015-001
Draft Implementing Technical Standards on the allocation of credit assessments of ECAIs to an objective scale of credit quality steps</td><td>Deadline
10.Apr.2015
23:59 CET</td></tr>
<tr><td>Company name:</td><td colspan="2">EuroRating Sp. z o.o. (Warsaw, Poland)</td></tr>
<tr><td>Disclosure of comments:</td><td>EBA, ESMA and EIOPA will make all comments available on their website, except where respondents specifically request that their comments remain confidential.
Please indicate if your comments on this CP should be treated as confidential, by deleting the word Public in the column to the left and by inserting the word Confidential.</td><td>Public</td></tr>
<tr><td></td><td colspan="2">The question numbers below correspond to Joint Consultation Paper on Mechanistic references to credit ratings in the ESAs´guidelines and recommendations (JC-CP- 2015-001).

Please follow the instructions for filling in the template:
⇨ <u>Do not change the numbering</u> in column “Reference”.
⇨ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph, keep the row <u>empty</u>.
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o If your comment refers to multiple paragraphs, please insert your comment at the first relevant paragraph and mention in your comment to which other paragraphs this also applies.
o If your comment refers to sub-bullets/sub-paragraphs, please indicate this in the comment itself.
Please send the completed template to JointCommitteeConsultation@eiopa.europa.eu <u>in MS Word Format</u>, (our IT tool does not allow processing of any other formats).</td></tr>
<tr><td>Reference</td><td colspan="2">Comment</td></tr>
<tr><td>General Comment:</td><td>In the Draft ITS (JC/CP/2015/001 of 6 March 2015) on the allocation of credit assessments of ECAIs to an objective scale of credit quality steps as many as 17 out of the total 26 (ie. 2/3) CRAs does not have attributed Credit Quality Step 1 (not to mention the CQS0) for any rating</td><td></td></tr>
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	category. The CQS1 (and CQS0) were attiributed only to a few largest credit rating agencies, operating for a very long time. The CQS1 has been atributed to some of these agencies for the 'AA' rating category, although the grounding contained in the mappings for the individual agencies (e.g. Standard & Poor's, Moody's, Fitch, AMBest) indicates, that "quantitative evidence is not clear" for that category and that CQS1 have been attributed on the basis of the fact, that "the meaning, relative position and time horizon of the rating category are representative of the final CQS". In addition, for certain agencies (e.g. DBRS) there has been attributed a higher CQS (in that case CQS2 for the 'A' rating category) than the one indicated by the quantitative factors (CQS3), also with a justification that that "the meaning, relative position and time horizon of the rating category are representative of the final CQS". At the same time, for all smaller CRAs there have been attributed Credit Quality Steps starting from CQS2 – even for the top 'AAA' rating category, despite the fact that for most of these agencies „the meaning, relative position and time horizon of the rating categories" 'AAA' and 'AA' are also representative of the CQS0 ('AAA') and CQS1 ('AA') in accordance with Annex 1 to the Draft ITS ("Reference meaning of the allocation of ECAI credit assessment is CQS"). The above phenomenon gives an impression that the various credit rating agencies in the mapping of their rating scales were not treated according to the equal, transparent and objective criteria. In case of the largest CRAs there has been applied a subjective increase (despite a lack of clear quantitative evidence) of the attibution of their highest rating categories ('AAA' and 'AA') to the CQS0 and CQS1, while in case of smaller CRAs – presumably due to an excessively rigorous approach – mapping proposed for their highest rating categories ('AAA' and 'AA') in most cases does not fit the meaning, relative position and time horizon of the rating category. Ipso facto, the proposed mapping contained in the Draft ITS discriminates the smaller agencies against the few largest CRAs. That issue is of a great practical importance, because in case of a final application of the proposed mapping (adverse for smaller agencies), there is a serious risk that these CRAs will not be designated by financial institutions (banks, insurance companies and others) as a nominated ECAIs and as a consequence their ratings will not be considered and applied by	

financial institutions for regulatory purposes. Moreover, issuers with a very low credit risk (i.e. potential candidates for credit ratings in the 'AA' category) would not even take into account the use of any smaller CRA (with no rating category attributed to the CQS1) for their credit assessment, because financial institutions would than apply for such issuers worse financing conditions (e.g. higher interest rates) due to the necessary higher capital requirements (e.g. 50% instead of 20%).

That situation creates potentially a vicious circle, because the CRAs without mapping of their highest rating categories in the CQS1 will not be able in the long term to obtain an adequate minimum number of credit ratings in the highest classes (at least 'AA-'), so that in time it would be possible to reclassify their highest rating categories for CQS1 and CQS0.

In addition, the lack of attribution of the highest rating categories to CQS1 in practice can potentially completely close for the smaller CRAs the market of credit ratings for covered bonds – safe securities which usually get credit ratings in the higher rating classes ('AA-' and above) and for which there should be attributed lower risk weights (20%). Issuers of these securities would be strongly discouraged from using services of CRAs without any rating category attributed to CQS1 (i.e. all smaller CRAs) and financial institutions would not be willing to designate such CRAs as nominated ECAIs, because they would than have to apply an disproportionally high risk weight for the rated covered bonds.

The exclusion even of the CQS1 (not mentioning the CQS0) for smaller agencies means, that in case of insurance companies these agencies will not have attributed any rating category to the two first (0 and 1) of the total seven credit quality steps. That means, that these agencies will likely not be designated as nominated ECAIs and that their credit ratings will not be considered and used for regulatory purposes by the insurance companies across the EU.

Apart from the matter of the attibution of the highest CQS (0 and 1) for smaller CRAs, one should pay attention also to the fact, that in the mapping included in the Draft ITS for some of the smaller agencies there have been attributed credit quality steps in a discontinuous manner (no rating category attributed to the CQS3, CQS4 or CQS5). This is true even in cases when the number of observed defaults (and the calculated actual default rate) does not indicate in

	any way the need for a more rigorous approach and classification of the individual rating categories to the CQS lower by two degrees. The lack of continuity of CQS attribution, as well as the attibution for the smaller agencies (in most cases presumably due to a low number of issued credit ratings and related to that excessively rigorous approach applied in the proposed mappings) generally lower CQS than that indicated by the expected long term default rate and by a rating scale description, undermines the credibility of these agencies among financial institutions (banks, insurance companies, investment companies), which – combined with a need to apply generally higher risk weights and higher capital requirements than the indicated by a given rating category – will further discourage financial institutions to designate those CRAs for nominated ECAIs and to use their credit ratings for regulatory purposes. Furthermore, the lack of continuity of CQS attribution with respect to a continous rating scale of a individual CRAs (in particular, if it is not justified by the observed historical default rates deviating negatively from the benchmark defaut rates) can cause „cliff effects": small change of a credit rating by one notch where there is a gap between the respective attributed CQS can trigger an disproportionally large Increase of risk weight. This may pose a risk of abstaining by the CRAs with mapping containing CQS gaps from ratings downgrades (despite of the existence of premises to do that) in cases where the rating change would result in a large skip in the capital requirements set out in the mapping. In addition to the related systemic risk associated to that, even the existence of such a threat can have a negative impact on the perception of such CRA by the market participants (e.g. financial institutions) and consequently on its credibility and position on the credit ratings market. The lack of continuity of CQS attribution without clear indications for doing so (ie. if it is not justified in the historical default rates excessive in relation to the benchmark default rates for particular rating categories) also significantly complicates the proposed mapping for rating users and it potentially increases costs associated with the use of external credit ratings by financial institutions. As a result, it is likely that rating users will only turn to the CRAs having a continous („traditional") CQS mapping and will disregard the others. All the above mentioned factors make the mappings proposed in the Draft ITS to be generally	

regarded as adverse and discriminatory for the smaller (and those active for a shorter time) CRAs. An application of the proposed mappings will likely result that these agencies will still not be recognized and designated as nominated ECAIs by the financial institutions in the EU (even on local markets) and their credit ratings will not be used for regulatory purposes. At the same time, issuers (in particular, the largest ones and characterized by the lowest credit risk) are likely to choose the CRAs with traditional mapping (ie. having CQS1 attributed to the highest rating categories and a continous CQS mapping for the whole rating scale).

All this will substantially hinder the development of the smaller CRAs, will impede competition on the credit ratings market in the EU, and thus it will foster the maintaining of the existing long-standing oligopoly of the few world's largest credit rating agencies, which in the proposed mapping have a far more favorable position in relation to the smaller agencies.

Last, but not least, one have to note, that the proposed mapping goes against the objectives and spirit of the CRA Regulation and CRR Regulation, which in principle support the development of competition on the credit ratings market and a reduction of systemic risk for the financial sector associated with a widespread use by financial institutions for regulatory purposes almost exclusively credit ratings of three world's largest CRAs.

It should be noted, that the resignation from the current excessive stringency (causing discrimination of the smaller CRAs) of the criteria for mapping smaller and/or new CRAs, which default definitions, expected long-term default rates and descriptions of rating scales are in line with the benchmarks for the individual CQS, would not involve a creation of any substantial systemic risk for the financial sector in the EU, because:

1) in order to obtain the registration in the EU all CRAs must meet stringent criteria set out in the CRA Regulation;
2) all registered CRAs are subject to an ongoing supervision by ESMA (which ensures adherence by the CRAs to the highest standards);
3) CRAs report semi-annually to ESMA information about their rating statistics and thus, in case of a possible future significant deviations of the actual default rates of individual CRAs

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	from their expected default rates, it can be quickly incorporated into the relevant adjustments in the mapping for those CRAs; 4) the individual smaller agencies registered in the EU have a very small market share and therefore even in case of the initial too favorable mapping for the individual CRAs in relation to the subsequent actual observed default rates, it would not pose a systemic risk to the financial sector in the EU, because the number of rated entities and a value of financial instruments rated by smaller agencies is (and in the foreseeable future still will be) very limited.	
Question: In respect of smaller ECAIs further investigation of the mappings could be undertaken. Please submit your views.	The main reason for the attribution for the smaller CRAs unfavourable mappings for the highest rating categories ('AAA' and 'AA') seems to be the requirement of a very large sample of issued credit ratings in these rating categories (to some extent this also applies to the problem of gaps in CQS attribution to lower rating categories). The requirement of a very large number of issued ratings and/or observed defaults is very difficult to meet for CRAs operating on a smaller scale and/or for local agencies (limiting the area of their business to one country or one region). Especially the requirement of having a representative (i.e. very large) number of issued credit ratings in the highest rating categories ('AAA' and 'AA') may make it impossible to obtain the CQS1 and CQS0 attribution by the local CRAs and/or for CRAs specializing in the developing markets. Such agencies usually don't issue ratings for the largest international corporations operating in developed markets and characterized by sufficiently high financial credibility to be able to obtain a credit rating in the 'AA' or 'AAA' rating category. Thus, such requirement may permanently close the way for these agencies to obtain CQS1 mapping, although their rating scales in the higherst categories correspond to the benchmark scale (contained in the Annex 1 to the Draft ITS) for CQS0 and CQS1. The requirement of a very large number of issued credit ratings in the highest rating categories (attributable to the CQS0, CQS1 and CQS2) is very difficult (or even impossible) to meet for	

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	smaller and/or local CRAs, and thus that requirement is discriminatory for the smaller agencies and consequently it significantly impairs their competitive position in relation to the few largest CRAs, which in censequence promotes the conservation of the oligopolistic nature of the market. Hence, in case of mapping for small and newly established CRAs it would be highly recommended a cancellation in the methodology of the mapping of the requirement of a minimum number of issued ratings for CQS0, CQS1 and CQS2. Instead, it should be possible to attribute at least the CQS1 to the highest rating categories ('AAA' and 'AA') and CQS2 to the 'A' category on the basis of stringency of the definition of default applied by a given CRA; a compliance of the the expected average long-term default rates applied by the agency with the relebvant benchmark default rates for CQS1 and CQS2; and on the basis of the compliance of the rating scale description of the CRA with the benchmark scale contained in the Annex 1 to the Draft ITS. A resignation of attribution CQS0 for brand new credit rating agencies could be acceptable. This should be accompanied by an ongoing monitoring of the actual default rates of individual CRAs done by ESMA and/or by EBA, to allow a possible future corrections in the mapping in the event that these indicators differed significantly from the benchmark default rates and from a description of the appropriate rating category. Also for lower credit quality steps (3-5) in the mapping for small and new CRAs it should be used to a greater extent an expert judgement and the mapping should be based more on restrictiveness of the default definition applied by a given CRA, on the compliance of the declared expected average long-term default rates assumed in the used rating methodology and of the description of the rating scale with the corresponding benchmarks. In general, if there is no significant quantitative evidence of the excessively high defalult rates in relation to the declared expected default rates and to benchmark rates, as well as in relation to the description of the given rating category in the rating scale, <u>there should not be used for the smaller CRAs excessively strict approach in CQS attribution, so as not to discriminate them</u>	

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	because of the limited scale of operations. A possible option for consideration is also applying a different approach for the small agencies already functioning on the market and having at least 3-5 years rating history and a different one for newly established CRAs with no rating history. In the first case (existing smaller CRAs) there should be carried out an immediate revision of the current initial mappings for the indvidual CRAs, taking into account the above remarks of a needed less stict aproach and of applying an expert judgement to a greater extent. In the second case (start-up CRAs with no rating history), after the registration by ESMA there could be applied initially some stricter criteria for mapping their rating scales (eg. lack of CQS1 and possibly lower CQS for the lower rating categories). After a certain period of time (eg. after 3-5 full years of operation of the given CRA or quicker in case of issuance by the CRA a large, representative number of credit ratings) and in the absence of actual non-compliance with the declared expected default rates applied in the rating methodology, there should be applied the same approach as for the functioning smaller CRAs.	
Article 1. ECAI Nr. 1		
Article 1. ECAI Nr. 2		
Article 1. ECAI Nr. 3		
Article 1. ECAI Nr. 4		
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Article 1. ECAI Nr. 13		
Article 1. ECAI Nr. 14		
Article 1. ECAI Nr. 15		
Article 1. ECAI Nr. 16	This comment was removed because it was submitted as confidential by the stakeholder.	
Article 1. ECAI Nr. 17		
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Impact Assessment 5		